Inquiry into Financial Products and Services in Australia

Submission to the Joint Committee on Corporations and Financial Services

18 August 2009

EXECUTIVE SUMMARY

Australians are seeking to build their wealth so that they can live comfortably once they leave paid employment.

To make their money work harder and go further, Australians are increasingly turning to investment options that, if held over the long term and are diversified with risk aligned with their lifestage, can increase savings by more than is possible through traditional banking products such as savings accounts.

There is a social and economic benefit derived from a community seeking to take care of its own lifestage and retirement needs. Responsible investing will assist these needs being met.

We note that the Federal Government's reforms of consumer credit regulation, margin lending and personal properties securities will establish a nationally consistent regulatory framework for the provision of credit in Australia. It will advance public policy outcomes relevant to the Committee's Terms of Reference including enhanced consumer protection measures and responsible lending requirements.

<u>Financial products</u>

ANZ seeks to make its products simple to understand and offers them in a transparent and responsible manner to ensure customers can easily make informed choices.

Margin Lending is a sensible way to invest in the share market when offered responsibly. In our view, this entails ensuring investors are well informed of the nature and risks of the product, investments are diversified, and Loan to Valuation Ratios (LVRs) are suitably prudent. Diversification and prudent LVRs are key aspects of ANZ's approach as these features can reduce the volatility of investments and reduce market and investment risks without sacrificing long-term performance.

<u>Financial services</u>

ANZ's financial planning business (ANZFP) sets high standards for its planners, supports them through ongoing education and training, monitors the quality of advice and addresses any issues that emerge promptly and fairly. Financial services licensees must be satisfied that the products they recommend are suitable for their various client risk profiles, which is achieved through the 'approved product list'. Properly trained planners and products matched to risk profiles are what our clients expect to be delivered by ANZ.

In our view, many of the current concerns about the financial planning industry would be addressed by the further professionalisation of the sector. This could be achieved by the establishment of a professional body that would set entry standards relating to: qualifications; education and ongoing continuing education; register planners; manage claims of misconduct and report findings to ASIC; and oversee a Compensation Fund. ANZ also supports the industry transition to fee-for-service in the provision of holistic financial advice and removing commissions. The obligation of financial planners to put the client's interests first should be legislatively enshrined in order to formally establish that financial advisers owe fiduciary duties to their clients.

It is important to take into account that the further professionalisation of the planning industry and reform of remuneration for planners offering full advice may increasingly put the cost of full advice out of reach of those with small sums to invest or who have simple investment needs. Consideration will also need to be given to how those who are unwilling or unable to afford this advice will be served.

To be able to provide basic financial advice and services to consumers who do not need relatively higher cost financial advice from a financial planner, ANZ has been exploring solutions for these customers through the provision of basic investment products that are straightforward to understand and that are supported by simple advice. Our submission contains more detail about this.

<u>Recent financial collapses</u>

Opes Prime

ANZ considers that the existing regulatory framework is comprehensive and contains extensive measures for the protection of both investors and retail users of financial products and service providers. ANZ is not aware of any evidence that the collapse of Opes Prime stemmed from any deficiency in the regulatory framework.

ANZ's own involvement with Opes Prime was limited solely to its capacity as a financier to Opes Prime. In respect of its dealings with Opes Prime, at no time did ANZ have any relationship with Opes Prime's customers. ANZ acknowledges the hardship faced by many clients of Opes Prime as a result of their relationship with the stock broking firm advisory group and the impacts of the global financial crisis and the significant downturn in world debt and equity markets. While ANZ does not consider this to have resulted from its actions, ANZ recognises that at times there were deficiencies in the management of its equity finance business and its relationship with Opes Prime. We have taken appropriate measures to address these issues, which are detailed in this submission.

Storm Financial

At no time did ANZ have a formal relationship with Storm. However, ANZ has currently identified around 160 of our customers who may have borrowed from ANZ to invest through Storm Financial. Following the review of the 160 customer files, we have determined that the lending decisions for a small number of customers did not comply with ANZ’s credit policies and we are undertaking further review to assess whether others could also be in that group.

We are in the process of contacting those customers who we have identified in our review where our lending policies were not followed correctly. Where it is established that there has been non-compliance with ANZ policies and procedures in lending to these customers we will ensure they are treated appropriately and fairly. Our approach will include assessing financial hardship on a case-by-case basis having regard to their individual circumstances and rectifying financial detriment that resulted directly from any action on ANZ’s part.

In addition, we are writing to all other customers we have identified to date, to whom we lent and who were also Storm investors, to invite them to contact ANZ on our toll-free number (1800 280 543) should they wish to discuss their financial circumstances relating to Storm.

We have established a single point of contact in our Hardship Team for affected customers and escalation to ANZ's internal Customer Advocate is available. If the case is not resolved to the customer's satisfaction, we will make available an independent external arbitrator at no cost to the customer.

We have also been working cooperatively with ASIC to provide assistance and information for its review of the collapse of Storm Financial.

We would be pleased to provide any further information about this submission, as required, and can be contacted as follows:

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1. ROLE OF BANKS IN PROVIDING FINANCE TO INVESTORS

(a) Creating a national framework for the regulation of consumer credit

The Federal Government is reforming a number of areas impacting consumer credit that are directly relevant to the Committee's Terms of Reference including:

- Consumer credit regulation: Federal, State and Territory Governments have agreed to transfer regulation of credit to the Federal Government. In addition, the Government is introducing a new licensing regime for all credit providers, intermediaries and debt collectors. From 1 January 2011, credit licensees will need to meet responsible lending obligations which require them to ensure the customer is able to afford to repay without substantial hardship and that the product offered is 'not unsuitable' for the customer's needs and objectives.

  ANZ made a submission to the Australian Treasury Green Paper on Financial Services and Credit Reform and also on the Exposure Draft (both attached). ANZ supports the national regulation of all forms of consumer credit to avoid inconsistency in credit regulation between States and Territories, and to create a single regime that can adapt to changes in the market place more rapidly.

- Margin lending: The Federal Government will regulate margin lending as a financial product under Chapter 7 of the Corporations Act 2001 (*Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 - Margin Lending*. This will ensure that, from 1 January 2011, anyone offering margin loans or providing advice in relation to margin loans must hold an Australian Financial Services Licence. Margin lenders will also be required to meet responsible lending obligations. This will allow them to provide a margin loan only if they are reasonably sure the borrower is able to afford the loan without suffering substantial hardship. The definition of margin loans in the legislation captures both standard margin loans, as well as more exotic securities lending products such as those used by Opes Prime. This approach is designed to ensure that borrowers and investors are fully informed about the product features of loans. The legislation will also clarify that the party providing the margin loan is responsible for informing the client directly of a margin call unless the client has given instructions to the lender to notify their broker or adviser instead. ANZ's policy is to inform both the client and their broker or adviser directly of a margin call.

  ANZ supports measures that seek to improve disclosure and retail borrowers' understanding of margin loans and made a submission to Treasury (attached) as part of the consultation process. ANZ welcomes the introduction of legislation that would help to reinforce the internal prudential guidelines that banks already generally apply in providing any form of loan. We would also support measures such as an upfront 'key issues' type disclosure which briefly describes the product, outlines the risks and details the costs so as to be of practical assistance to investors.

- Personal Property Securities: The Federal Government will create a national system of personal property securities law that governs how personal property may be used as security for a loan. This will establish a single national personal property securities register that lenders can use to determine whether property (excluding land) provided as security for a loan is subject to any competing claims.

- Comprehensive credit reporting: the Federal Government is considering developing a framework to implement the Australian Law Reform Commission's findings concerning the need for more comprehensive credit reporting arrangements for Australia. ANZ supports comprehensive credit reporting as an important tool in facilitating responsible lending decisions. We understand an exposure draft of the proposed legislation will be released by the end of the year.

(b) ANZ Responsible lending and responsible products

ANZ is conscious of its obligations to lend responsibly. ANZ's Customer Charter outlines our commitment to providing convenient, simple and responsible banking services to our customers. It sets out the specific service standards our customers should expect us to meet, including a formal commitment to lending in a responsible and transparent way. While the focus of the responsible lending promises is credit cards, the underlying philosophy is that we will not extend more credit than we assess the customer is able to repay. Each year, our external auditors review our performance against our commitments to our customers and we report the results publicly.

(i) Community understanding of investment fundamentals

Raising understanding of investment principles such as the relationship between risk and return and the importance of diversification in investing is a longer term endeavour and we see this as complementary to the regulatory framework that protects consumers.

As part of our commitment to financial literacy and inclusion, ANZ has initiated and funded ongoing research into levels of adult financial literacy, financial exclusion, and causes of financial difficulty in Australia. This research has led to changes in ANZ's business operations, as well as the development of programs to improve financial literacy levels, especially among the most disadvantaged in our community.

ANZ has undertaken several major research projects on financial literacy. The first, published in 2003, was Australia's first ever national survey of Adult Financial Literacy and provided a benchmark for future research. We published the results of follow-up Adult Financial Literacy surveys in 2005 and again in 2008.

Findings on investment fundamentals

Generally, our research has demonstrated that of those who do invest their understanding of investment fundamentals could be improved. Despite a plethora of information freely available, through such sources as www.anz.com or ASIC's FIDO site www.fido.gov.au, our 2008 survey showed a somewhat mixed picture with respect to investing and superannuation.

There were improvements in people's understanding of some investment fundamentals including:

- more people said they would not invest in "*an investment advertised as having a return well above market rates and no risk*", up from 46% in 2002 to 52% in 2008; and
- More people understood that "*short term fluctuations in market value can be expected, even with good investments*", up from 63% to 67% during this period.

However, on a less positive note:

- The proportion of investors who considered diversification of investments to be very important has remained unchanged over the last 6 years - 50% in 2008 compared with 51% in 2002.
- Of those who have used a financial planner, around one in three (35%) did not consider the possibility of a conflict of interest influencing the advice they received.

For our part, ANZ has used and will continue to use the results of our financial literacy research studies to improve our own operations and business practices and to guide product development. ANZ has focussed on making its products simple to understand and offering them in a transparent and responsible manner. Our aim is to ensure customers can easily make informed choices.

(ii) ANZ Personal Loans

While personal loans are available for customers wanting to invest in shares, ANZ does not actively market Personal Loans for that purpose. While ANZ always asks the purpose for which a loan is sought, our focus is on extending a loan the customer can afford. Investment purposes account for only 0.5% of our portfolio.

(iii) ANZ Margin lending

Margin Lending is a sensible way to invest in the share market when offered responsibly. In our view, this entails ensuring investors are well informed of the nature and risks of the product, investments are diversified and Loan to Valuation Ratios (LVRs) are suitably prudent. Diversification and prudent LVRs are key aspects of ANZ's approach as these features can reduce the volatility of investments and reduce market and investment risks without sacrificing long-term performance.

ANZ has over 13,000 borrowers (as at 30 June 2009) that utilise our Margin Loan products. A search of these customers has not revealed any association with either Opes Prime or Storm Financial Ltd. We did not offer any products from either party as approved investments.

About margin loans

For the Committee's information, we have outlined ANZ's approach to its margin lending product.

A margin loan allows customers to borrow money to invest in shares or managed funds by using their share portfolio as security for the loan. A margin loan can enable customers to diversify their portfolios by providing a larger pool of money to invest in a wider range of shares or investments.

Diversification and prudent LVRs are key aspects of ANZ's approach as these features can reduce the volatility of investments and reduce market and investment risks without sacrificing long-term performance.

Margin calls

When borrowing to invest, it is important to remember that while returns can potentially increase, losses can potentially increase as well. Margin calls are a way of limiting losses.

How does a margin call occur?

Falls in the market value of a portfolio can make the Security Value lower than the amount borrowed. To assist in managing the portfolio, ANZ provides a buffer of 5% (explained in the next section) to give customers additional time to take the appropriate actions to return the portfolio to a suitable security position.

If the 5% buffer is exceeded, ANZ will place the account in "margin call." ANZ will then attempt to contact the customer who must either increase their security or repay the loan to the required level.

What is a buffer and how does it work?

The buffer exists so that small falls in the market value of a portfolio do not result in a margin call. A margin loan account is 'in the buffer' if the loan balance exceeds the security value by a small amount – less than 5% of the value of the securities.

If a margin loan account is in buffer, further funds may not be borrowed until the account is restored to within normal LVR limits. Whilst there is no need for further action in buffer, it is a reminder to the customer to review the portfolio and to take action to restore it to normal LVR limits and avert a potential margin call.

Reducing the likelihood of a margin call

There are several strategies investors can use to reduce the likelihood of a margin call:

- borrow conservatively;
- monitor the portfolio and loan account regularly (real time data and portfolio position is available on My Portfolio, a web based portal offered by ANZ Margin Lending to its customers);
- ensure the portfolio is well diversified to reduce volatility; and
- pay interest monthly rather than allowing it to capitalise on the loan.

Clearing a margin call

If the market falls and a margin call occurs on an account, ANZ's policy is to contact both the customer and their adviser.

A margin call must be cleared by close of trade the following business day. There are several ways to do this:

- deposit funds into the loan account or linked cash management account;
- contribute additional ANZ approved securities (shares or managed funds); or

- sell part or all of the existing portfolio to pay down the loan balance so that the Security Value of the portfolio is more than the loan.

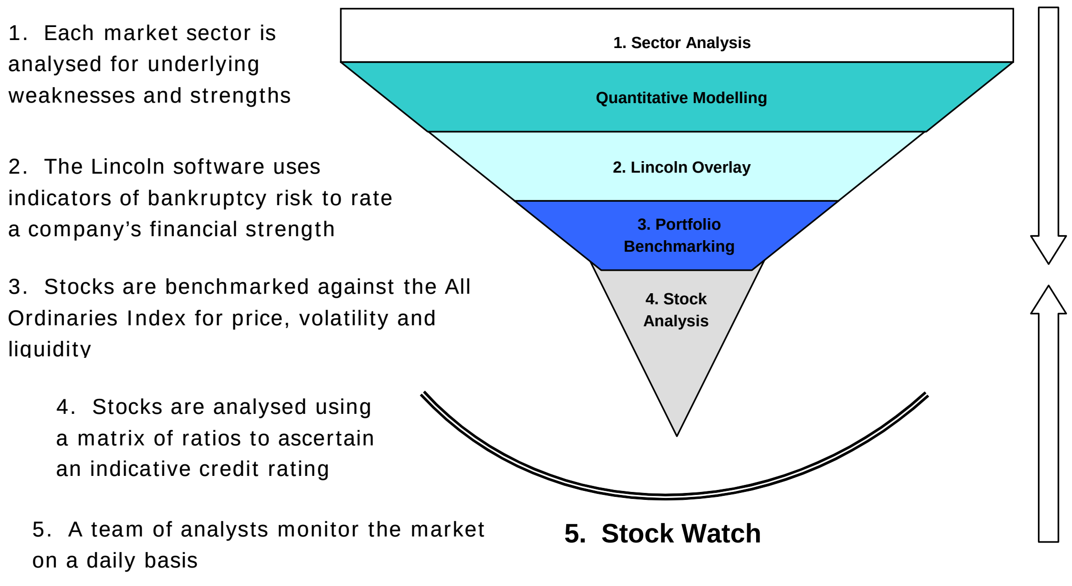
Legal title to the asset resides with the customer until sold. ANZ cannot sell the assets unless a margin call is not met or the customer otherwise consents.

If the customer is not able to clear a margin call by the close of trade the following business day after their account has entered margin call, ANZ will sell enough securities so that the Security Value of the portfolio is more than the loan. This may occur even if we were unable to contact the customer or their adviser. It is important to note that once in margin call, the entire amount of their margin call must be cleared.

<u>ANZ's experience of margin lending</u>

ANZ's approach to risk management is designed to limit investors' exposure to equities or managed funds that are subject to abnormal declines. This approach combines quantitative risk modeling with more targeted analysis of individual stocks and sectors. The following diagram illustrates this approach.

Diagram 1: ANZ's risk management approach



The outcome of ANZ's risk approach is the allocation and adjustment of LVRs and the appointment to, or removal from, our Approved Investment List of stocks.

<u>Setting LVRs</u>

Along with understanding and being comfortable with the risks involved with using margin lending products, the principles of diversification and the setting of appropriate LVRs assist customers to manage risk relative to their risk appetite. LVR ratios vary across the industry and ANZ takes a conservative approach with an average LVR of 40%.

The LVR is calculated for individual stocks and managed funds. To ascertain the appropriate LVR, an investment is analysed to determine its financial strength, price volatility and liquidity in the market. These three factors are used to estimate the likelihood of an investment falling in value at greater than the average or benchmark (e.g. the All Ordinaries Index). The lower the likelihood of such a fall, the higher the LVR will be.

For example, a small mining explorer that has relatively few shares on issue, a price that fluctuates dramatically and is financially vulnerable, will have an LVR of 0% to 40% (depending upon the analytical outcome). BHP, on the other hand, has an LVR of 75% which is the maximum for a single stock. Lending against illiquid and small cap stocks is only responsible using modest LVRs or within a diversified portfolio.

ANZ strongly supports and recommends diversification as an investment principle. ANZ margin lending is mostly for diversified portfolio investing as the greatest risk is in single stock or concentrated exposures. A diversified portfolio significantly reduces the probability of margin calls occurring. ANZ offers borrowers a Diversified Margin Loan product that rewards diversification with slightly higher LVRs.

Additional safeguards implemented by ANZ Margin Lending include:

- Stock concentration limits whereby ANZ Margin Lending's total exposure to a single stock does not exceed 5% of total market capitalisation;
- A limit on the maximum credit exposure to a single investor with a non-diversified portfolio;
- Exposure limits to company directors and senior company officers who borrow against their own stock;
- Monitoring total exposures by customer and individual investment;
- No lending directly to managed funds; and
- "Know your Client" analysis to limit the chance of lending to unscrupulous managers or advisers.

Margin Lending and the global financial crisis

ANZ's Margin Lending portfolio was conservatively geared pre-crisis. The loan book was characterised by large numbers of relatively small accounts from ANZ retail channels and small numbers of large accounts, principally sourced from ANZ Private Bank. Gearing levels and utilisation of credit limits were relatively conservative across all segments and few clients contributed sufficient security to utilise their entire credit limit. The market risk-based asset lending approach, outlined above, limited single-stock exposures that posed high risk of "breakthrough" from market to credit risk.

The last 18 months have subjected the Margin Lending portfolio to unprecedented volatility. This resulted in a very difficult environment for margin lending with sustained, broad falls across the market punctuated by sharp single-day volatility and a significant decline in market liquidity. This was exacerbated by the collapse of a number of stocks, including groups of related entities.

The impact on the portfolio included:

- A reduction in total loan portfolio by 33%. Assets mortgaged as security fell by 40%;
- Little net change in active client numbers as the exit of repaying clients has been largely negated by the entry of new clients;
- Credit limit utilisation fell as clients reduced their borrowing but retained their facility limits; and
- Gearing levels were maintained as clients reduced their borrowing in line with the fall in value of their portfolios.

In summary, the fall in the market resulted in a reduction in the average loan size by client as well as a reduction in limit utilisation. Borrowers maintained their limits but, on average, reduced their overall loans.

Clients have maintained similar gearing levels by reducing their loan balances as the value of their security falls. A combination of margin calls and clients' own de-leveraging strategies has reduced exposures in line with reductions in security.

While volatility has caused record numbers of margin calls, cases of negative equity, where customers lose more than their initial investment, are very rare (18 of ANZ's clients are on repayment plans).

2. FINANCIAL PLANNING

Australians are seeking to build their wealth so that they can live comfortably once they leave paid employment.

However, it is widely acknowledged that many Australians may not be on track to generate sufficient wealth to achieve a reasonable standard of living in retirement. Smaller superannuation benefits mean more retirees are expected to qualify for a full or part government-funded pension.

To make their money work harder and go further, Australians are increasingly turning to investment options that, if held over the long-term and are diversified with risk aligned with their lifestage, can increase savings by more than is possible through traditional banking products such as savings accounts.

Current issues

There have clearly been occasions when consumers have been let down, and in some cases significantly so, when they have sought financial advice. Retirement savings have been lost and public confidence in the industry has been undermined. There is accordingly a case for raising standards in the financial planning industry.

Given the ageing of the population and the need, as well as the aspiration, of more Australians to provide for their retirements, the Committee may wish to consider both:

- the need to raise standards within the financial planning industry; and
- the need to do so such that financial services are accessible by a broad section of the community.

Higher standards are likely to have the effect of further raising the cost of compliance and providing advice and may make full service advice less affordable and accessible for those with smaller sums to invest or simple investment needs.

While there is a clear need in many cases for 'high touch' holistic financial advice, many Australians who aspire to build wealth have relatively simple financial needs and may not need, see value in, or be able to afford to pay for advice of this kind.

There is a social and economic benefit derived from a community largely seeking to take care of their own lifestage and retirement needs. Responsible investing will assist these needs to be met. For example, a young person in their 20s starting their first job with $1000 to invest, with a view to saving a deposit to buy a home in their 30s, does not require sophisticated holistic advice, and nor is it economical to seek it. For this category of consumers, ANZ submits that there should be other ways to meet their needs.

2.1 Suggested Framework – A two pronged approach

ANZ suggests there is merit in the Committee considering a two pronged approach to the delivery of financial services that includes (i) a full advice option as well as (ii) the provision of cost effective wealth solutions as another option. Such an advice continuum is illustrated in the Diagram on page 14.

(i) Full Service Advice

Enhance the professionalism of the financial planning industry to improve the quality of investment advice delivered to consumers who require holistic financial advice that takes account of the entirety of their financial circumstances.[1]

In our view many of the current concerns about the financial planning industry would be addressed by increasing the professionalism of the sector. We support tighter regulation of the use of the term 'financial planner' to describe those who provide holistic advice. Our view is that, for holistic financial advice, it should be clear that the financial adviser owes a fiduciary duty to the client and accordingly must act only in their interests and must not put themselves in a position where there is conflict with their duty to the client.

Specifically, in order to increase the professionalism of the sector we would support reforms to the sector based on the following principles:

<u>Raising standards</u>

- *Professional body:* A legislatively backed professional body should be established that would be responsible for licensing and registration of planners, setting qualifications, education and training standards and overseeing a disciplinary body that would review conduct by members. This body would be similar to professional bodies that operate in the medical and legal professions and could operate under a similar regulatory framework to that applying to the ASX over ASX participants.

<u>Entry to the profession</u>

- *Registration:* Full Service Advisers should be required to be individually registered by the professional body in order to be permitted to use the name Full Service Adviser. Registration would be contingent on appropriate professional qualifications and continuing professional education.
- *Education Standards*: There should be higher minimum standards than currently required.

<u>Conduct</u>

- *Fiduciary duty to client:* The obligation of Full Service Advisers to put the client's interests first should be legislatively enshrined.
- *Remuneration:* Full Service Advisers should charge fees for investment advice and should not be permitted to receive commission payments. Clients should be able to choose how to pay the fee for advice, whether out of the product or upfront. We define a fee for advice as a payment made by the client to the planner for their

[1] For the purposes of this paper we use the expression Full Service Advice.

professional advice. We do not think that the basis for calculating fees should be prescribed i.e. it would be acceptable for fees to be calculated as an hourly rate, a percentage of a client's investment or some other measure. What is critical is the client must be able to stop paying the fee should they believe they are not getting value from their adviser. This differentiates it from a commission which is a cost embedded in the product as part of its design, i.e. under current commission structures, if a client leaves an adviser the trailing commission continues to be charged against their account. In these circumstances if the client does not request that the commission be assigned to another adviser, the commission margin is kept by the product manufacturer.

Oversight

- *Misconduct*: the professional body established by legislation should include a disciplinary body to oversee and adjudicate on misconduct by members of the profession and have the power to fine, discipline and deregister individual participants. The findings and any action taken should be reported to ASIC. The combination of individual registration of planners and professional body oversight should help reduce the incidence of 'rogue planners' moving from licensee to licensee.
- *Compensation Fund:* the professional body should establish and administer a compensation fund that is available to meet customer claims, that are established, arising from misconduct of financial planners. Those providing financial advice should hold professional indemnity insurance and the compensation fund should indemnify those who are unable to obtain compensation through their advisers' insurer for negligent advice or fraud.

Accessibility

- *Tax deductibility:* to improve accessibility and affordability of financial advice, it should be tax deductible in the same way that advice provided by accountants and tax advisers is tax deductible.

(ii) Cost Effective Wealth Solutions

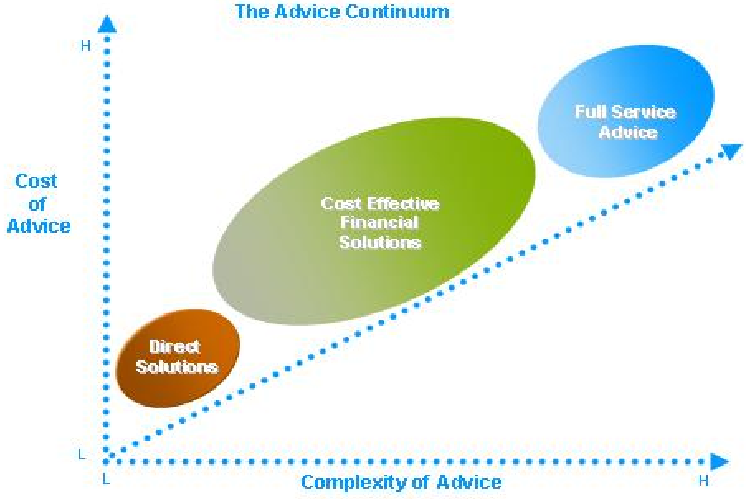
Establish a framework for cost effective wealth solutions for customers with simple needs.

Different frameworks should be discussed under which cost effective wealth solutions may be delivered. What we advocate is that there be a clear delineation between those who provide Full Service Advice and those who offer cost effective 'wealth solutions'. This should ensure that consumers are able to identify the nature of the service being given to them and to understand its implications.

We note at the outset that these possible courses of action are complementary and that they should be implemented concurrently to ensure that the two competing objectives of increased standards and accessibility can be met. If enhancements are made to professionalism on the one hand without addressing issues of affordability on the other, this could have an adverse impact on accessibility.

We also note that there would need to be a period of transition necessary to allow what is discussed here.

Diagram 1: The advice continuum



ANZ's Approach to Financial Planning & Cost Effective Wealth Solutions

ANZ has made progress in:

- transitioning its Financial Planning business towards a fee for advice model (a transition that is underway but not complete); and
- developing cost effective wealth solutions under the current regime.

We elaborate on this progress in the following section.

(a) ANZ Financial Planning – the transition to delivering Full Service Advice

ANZ Financial Planning (ANZFP) is in transition to a full service advice model and the associated remuneration structure. Currently our model is a hybrid of both fees and commissions which will be discussed in greater detail below.

Overview of ANZ Financial Planning

ANZ Financial Planning (ANZFP) is a significant financial planning business within ANZ's Wealth business unit, which is part of ANZ's Australia Division. ANZFP has a corporate Head Office with representation across Australia organised into four State-based regions headed by a State manager. The State Manager is responsible for the function of individual Practices in each region that are headed by a Practice Manager.

ANZFP currently has 21 Practice Managers managing 321 Financial Planners across Australia. ANZFP has $9.7 Billion under management for 110,000 clients.[2] Our existing in-force personal insurance book is $97m in premiums across 66,000 clients.

ANZFP Planners provide personal rather than general financial advice. This means that ANZFP Planners must make inquiries about the relevant personal circumstances of the client and give advice that is appropriate to the client given those circumstances.

[2] ANZFP services are offered to all customers of ANZ, other than high net worth customers who are clients of ANZ's Private Bank.

Legislation mandates a range of disclosures that must be given to clients receiving financial advice. These include:

- A Statement of Advice (SOA) that sets out in detail the financial advice given and its basis; and
- A Product Disclosure Statement for any financial products recommended.

ANZFP's Operating Framework for Financial Planners

ANZFP's business sets high standards for its Planners, supports them through ongoing education and training, monitors the quality of advice and addresses issues that emerge promptly and fairly. ANZFP has put in place a framework that seeks to ensure that it meets its obligations under law. The core components of ANZFP's framework are:

- Recruitment, Authorisation of Planners and Training
- Educational Standards
- The Formulation and Preparation of Advice
- The Cost of Advice for Clients
- Adviser Remuneration
- Management of ANZFP's Approved Product List
- Monitoring and Supervision of Advisers

Recruitment, Authorisation of Planners and Training

All ANZFP Planners are employees of ANZ. As a prerequisite to employment with ANZFP, a Planner must show evidence of: (i) their successful completion of RG 146 training requirements; (ii) the type of advice they are qualified to offer; (iii) the products they advise on; and (iv) the markets in which they operate.

ANZFP Planners are not permitted to provide financial advice until issued with an Authorisation Letter and Practising Certificate. The Authorisation sets out the financial services a Planner is permitted to provide and products the Planner is permitted to advise upon. Planners are authorised to give advice only in relation to the areas in which they have been trained and assessed.

ANZFP may suspend or revoke this authorisation where a Planner does not or is unable to meet their regulatory obligations and their obligations to the client and ANZFP. This may be done immediately and without prior notice to the Planner.

ANZFP provides extensive and ongoing training to its Planners both through internal and external specialist, accredited providers.

Initial Training

Before they are authorised by ANZFP to provide financial advice, new Planners must undertake intensive induction training. The induction training is a four-week program designed to introduce and test Planners on the ANZFP advice process, quality requirements and provide specific product accreditation.

Following initial training, an Annual Training Plan is developed for each Planner and these are centrally maintained and monitored by ANZ Advisory Services and ANZFP Risk in a training register.

Ongoing Training

Throughout their career with ANZFP, Planners must:

- Complete a minimum of 30 Continuing Professional Development (CPD) points each year. CPD education can include such information as refresher training, best practice education, updates on regulatory changes and compliance policies and is conducted by both internal and external specialist providers;
- Complete a minimum of 120 CPD points every 3 years if they have the Certified Financial Planner (CFP) designation. CFP is the recognised industry body certification;
- Complete any other training requirements identified and agreed in the Planner's Annual Training Plan; and
- Complete any other training mandated by ANZFP.

Product Training

Although not a specific legislative requirement, Planners must also undertake Product Knowledge Accreditation programs to ensure they have the knowledge and skills to advise on the products available to clients through ANZFP's business. No Planner may offer products for which they are not accredited. Planner training includes training on asset allocation and diversification.

Educational Standards

From 1 October this year ANZFP will require all advisers to exceed current legislated educational standards. We have set a transition period to achieve this goal with a target date of 1 April 2011.

The minimum entry standard for new Planners will be the attainment of an Advanced Diploma in Financial Services with preference given to those who have an FPA approved Degree in Financial Planning. Senior Financial Planners will require either an FPA approved Degree/Masters Degree in Financial Planning or the Certified Financial Planner (CFP) designation. ANZFP is making a significant investment in its Planners' professional development and reimburses all Planners for any approved ongoing education costs.

The Formulation and Preparation of Advice

ANZFP utilises COIN Financial Planning Software for financial modelling and plan preparation. Asset allocation benchmarks linked to risk profiles are built into the plan utilising advice from our external research provider, van Eyk Research. We have a centralised paraplanning unit which is responsible for the production of all complex financial plans.

The Cost of Advice for Clients

Initial Advice

In response to public debate about perceived and/or actual conflicts of interest in the financial planning sector, ANZFP now charges a fee for the provision of initial advice as documented in a Statement of Advice.

A minimum fee of $220 (inclusive of GST) is charged for insurance advice and a minimum fee of $550 (inclusive of GST) is charged for investment, superannuation or retirement advice.

Implementation of Advice

Should the client wish to progress with implementing their investment advice ANZFP receives revenue via an implementation fee (which is the fee charged for implementing the product solution contained in the advice) and/or product commissions. This implementation fee is based on a percentage of funds invested and capped at 1.1% (inclusive of GST).

Ongoing Advice

ANZFP offers its higher net worth customers an ongoing financial advice service (Prime Access) for a yearly fee. Under this scenario any investment product commissions are rebated back to the client. The minimum annual fee for this service is $2,750 p.a. (inclusive of GST).

Ongoing service for non-fee paying customers is paid for by trailing commissions embedded in product solutions and received by ANZFP. These are based on a percentage of funds under advice.

Ad-hoc Advice

ANZFP may charge a fee for assistance or services it provides during a financial planning consultation separate to the scenarios outlined above. A minimum fee of $165 (inclusive of GST) may be charged for each 30 minutes (or part thereof) session.

Adviser Remuneration

ANZFP Planners receive a salary and quarterly bonus based on revenue targets. These targets are determined for each Planner based on a number of criteria. The revenue-based incentives for Planners include revenue from any source including initial advice, implementation and ongoing advice. Incentives are not biased towards a particular product, class of product or class of revenue. Planners are not eligible to receive a quarterly bonus if they have not met ANZFP requirements for compliance and advice quality.

Management of ANZFP's Approved Product List

There is an expectation with our clients who rely on the ANZ brand that the products ANZFP advise on will perform in line with the risk and return guidelines set out in their Statement of Advice.

Financial services licensees must be satisfied that the products they recommend are suitable for their various client risk profiles. ANZFP discharges this responsibility by establishing an 'Approved Product List' (APL). Subject to tightly controlled exceptions, (e.g. where a customer seeking ANZFP services brings with them an existing investment portfolio) ANZFP Planners may only make recommendations to clients in relation to products on the APL. Our APL has historically taken a conservative approach to investment risk consistent with our reputation as a major Australian financial services institution.

ANZFP has in place a product selection and review Committee to ensure that there is a robust decision-making process for the inclusion and retention of products on its APL. The Committee comprises senior members of the ANZFP management team and a senior representative from Risk.

Monitoring and Supervision of Planners

ANZFP's monitoring and supervision framework exists within an ANZ company-wide compliance and risk management framework.

This requires the identification of the primary regulatory compliance obligations impacting ANZFP and the regular preparation and execution of a Compliance Plan to:

- identify compliance risks;
- identify controls in place to mitigate those risks;
- put in place a testing programme to ensure those controls are effective; and
- put in place treatment plans to deal with any compliance risks that may not have sufficient, or sufficiently effective controls.

To do this ANZFP adopts the following measures:

Planner Audit/Review Process

ANZFP has a Quality Assurance Review process in place to regularly review Planners and samples of their customer files. This function is undertaken by Quality Managers (QMs) located in all States who report to ANZ Risk, rather than to the ANZFP business.

The annual Quality Assurance Review examines a Planner's advice to clients and the link between the client's individual situation and the quality of the strategies presented; their compliance and strategy knowledge and back office administrative processes.

Quality Assurance reviews use a scorecard to assess those factors that contribute to ensuring the key legislative requirements are met.

Incident/Breach Management & Reporting

ANZ has in place an incident reporting and management framework to ensure that it is able to meet its legal incident reporting obligations and to enhance its ability to identify and address systemic issues. This framework is supported by a bank-wide incident recording, escalation and monitoring database that enables us to record, manage and report on incidents internally as well as to regulators when needed.

ANZFP supports this framework and ensures that all of its staff have a clear understanding of their responsibilities for identifying and reporting incidents by ensuring that all Planners and their managers are informed about their obligations to identify and escalate incidents.

Using the quality review information

Information obtained from QM reviews of financial plans and Planners and incident reports are used by ANZ Risk and ANZFP management to identify and address any issues and continuously improve.

Consequences for a Planner

Consequences for a Planner may include remedial training, loss of bonus, pre-vetting and post-vetting of future client files, additional targeted audits, revocation of Practicing Certificate or dismissal.

A Planner who fails their audit is not entitled to receive a bonus for the quarter in which that audit occurs. If the failure is less severe the Planner is entitled to earn 50% of the bonus provided they undertake and successfully complete the remediation actions set for them within specified timeframes.

Serious adverse findings or repeated audit failure may result in formal first and final warning letters or termination of employment.

Transition period required for a complete shift to a fee for advice model

At present the transition of ANZFP towards a pure fee for advice model for new customers is underway but not complete. This transition should be possible by 2012, provided that there is a clear mechanism permitted under any new regime for providing cost effective wealth solutions as described in our submission.

(b) <u>Cost effective wealth solutions developed by ANZ in the current regulatory environment</u>

ANZ understands from its customers that many are inhibited from investing for several reasons:

- *Fear* of making a mistake
- *Effort* required to get into investing in terms of locating a Planner, conducting research, finding a broker
- *Time* it takes to maintain and manage an investment portfolio and set it up
- *Knowledge* required and time and effort required to build understanding
- *Cost* of financial advice, transaction costs and fees for broker services etc
- *Risk* of losing their investment, especially if based on a lack of knowledge.

Currently, for those unwilling or unable to pay for full service financial advice, there are two options:

(i) invest in simple investment products that are easy to understand and do not require high levels of training for those suggesting them; or

(ii) obtain advice but pay for it through commissions or other forms of product revenue spread across the life of the product.

This information has been used to help ANZ design some new products that assist consumers who want to diversify their risk and invest conservatively, especially those with simple investment needs or with small sums to invest and who find the cost of full advice uneconomical for their needs.

ANZ Lite advice pilot

ANZ is piloting a 'simple advice' model. Called '*My Advice',* the model provides one-off advice via a phone call rather than holistic and ongoing advice. It is designed to provide retail consumers with an appropriate recommendation to either assist them to get started on the wealth accumulation journey or to take steps to protect their family assets against unforeseen circumstances.

To access this advice, a customer calls a 1800 number to speak with a qualified financial planner based at ANZ's Australian Call Centre. These advisers are qualified to provide recommendations on a select range of ANZ savings and investment products that may be suitable to a customer's needs and objectives. The advisers are remunerated by base salary only. Following a conversation about their current situation and future aspirations customers are provided with a Statement of Advice in plain English delivered by email or post.

The investments this service can advise on are limited to selected ANZ bank and investment products, such as the Online Investment Account and Term Deposits. This product offering will be expanded, over time, to include insurance and other investment products appropriate to this segment of the market that requires only limited advice.

No complex advice is provided and customers are advised of this during the consultation. Customers seeking full financial advice are directed to ANZFP.

My Advice can help customers to:

- Get started with investing from $1000;
- Find an appropriate savings or investment product; and/or
- Better understand the risk and return associated with their investments.

ANZ believes this option could efficiently provide advice to those with smaller amounts to invest who do not need or want to pay for comprehensive financial advice. For the pilot, some clients are charged a one-off fee-for-service of $100 for the *My Advice* service. The early customer feedback concerning the fee is mixed as those with small sums to invest may still find this initial fee too expensive. In any event, the costs of providing this advice model are still higher than the fee-for-service charged and, as long as product fees are clearly and simply disclosed we see a continuing role for some cost recovery through product fees.

Online Investment Account

The latest Australian Share Ownership study (ASX 2009) shows that 6.7 million people, or 41 per cent of adults, participate in the share market. Of these, some 36% are direct investors in shares. While Australians have some of the highest rates of share ownership in the world, as stated previously, our research tells us that many do not invest because of lack of knowledge, fear of investing, not having enough time to devote to managing a share portfolio and the costs and complexity of using brokers.

In response to this research, ANZ has introduced the ANZ Online Investment Account that offers retail banking customers the combination of convenience, simplicity, low fees and diversification. This is a first-of-its-kind share investment product which looks and feels like an online savings account, but is an investment in a fund that tracks the S&P/ASX 200 Index. This means the investment increases or decreases in value, excluding the effects of fees and charges, depending on the daily fluctuations of the index on the ASX.

Customers can monitor their investment performance or increase/decrease funds invested at any time using ANZ Internet Banking and their account details can be viewed online in a simple account statement. ANZ discloses the investment risks prominently, in plain English, including that the account is linked to the performance of the Australian share market which generally has a higher risk than fixed interest investments, term deposits, and traditional savings accounts.

ANZ's Online Investment Account product is in response to customers who may be investing for the first time in the share market and want to do so without the costs and inconvenience involved in using brokers and having to follow individual stocks. It also suits those customers who do not want to spend time and effort managing a share portfolio, including choosing specific stocks and tracking various investments, but who want the higher, longer-term returns that can be derived from diversified share investing.

The ANZ Online Investment Account has relatively low transaction and management costs. Compared to traditional managed funds, the product charges a low management fee (1% pa). First time investors can contribute small amounts on a regular basis – the product allows customers to contribute from as little as $100, for which they will be charged transaction costs of $0.25. When compared to online brokers – this is a considerable cost saving per transaction for a diversified investment.

3. SECURITIES LENDING AND OPES PRIME

ANZ considers that the existing regulatory framework is comprehensive and contains extensive measures for the protection of retail users of financial products and service providers.

In particular, the framework provides a sound base for protecting retail clients from loss that could be suffered as a result of purchasing and dealing with financial products through the requirements that financial service providers:

- hold an Australian financial services licence;
- provide a Financial Services Guide, Statement of Advice and Product Disclosure Statement (as appropriate) when providing financial advice or dealing in a financial product; and
- have a reasonable basis for advice provided to a retail client, having regard to the client's personal circumstances (after having made reasonable inquiries regarding those circumstances).

ANZ is not aware of any evidence that the recent corporate collapses, such as Opes Prime, stemmed from any deficiency in the regulatory framework.

Nevertheless, particularly with respect to margin lending facilities, ANZ considers that the existing regulatory regime would be bolstered by the introduction of statutory responsible lending obligations proposed in the *Corporations Legislation Amendment (Financial Services Modernisation) Bill*.

ANZ acknowledges the hardship faced by many clients of Opes Prime as a result of their relationship with the stock broking firm advisory group and the impacts of the global financial crisis and the significant downturn in world debt and equity markets. While ANZ does not consider this to have resulted from its actions, ANZ recognises that at times there were deficiencies in the management of its equity finance business and its relationship with Opes Prime and has since taken appropriate measures to address these issues.

Securities lending and equity finance

Until its collapse in early 2008, Opes Prime provided securities lending (including equity finance) facilities. In general terms, securities lending refers to the transfer of securities from one party to another in return for cash or other securities ("collateral"). The party who receives the securities is generally obliged to return them (or equivalent securities) either on demand or at the end of an agreed term, subject to repayment of the collateral.

Equity finance is a particular subset of securities lending in which the value of the cash collateral advanced to the party providing the securities ("customer") is generally less than the value of the securities received by the party providing the cash collateral ("financier").

The principal distinction (from a legal perspective) between margin lending and equity finance is that with the latter the customer transfers all legal and beneficial interest in the securities to the financier.

A good description of securities lending and the commercial context in which it occurs is contained in the judgment of Justice Ray Finkelstein in *Beconwood Securities Pty Ltd v Australia ad New Zealand Banking Group Limited* [2008] FCA 594. A copy of the judgment is attached.

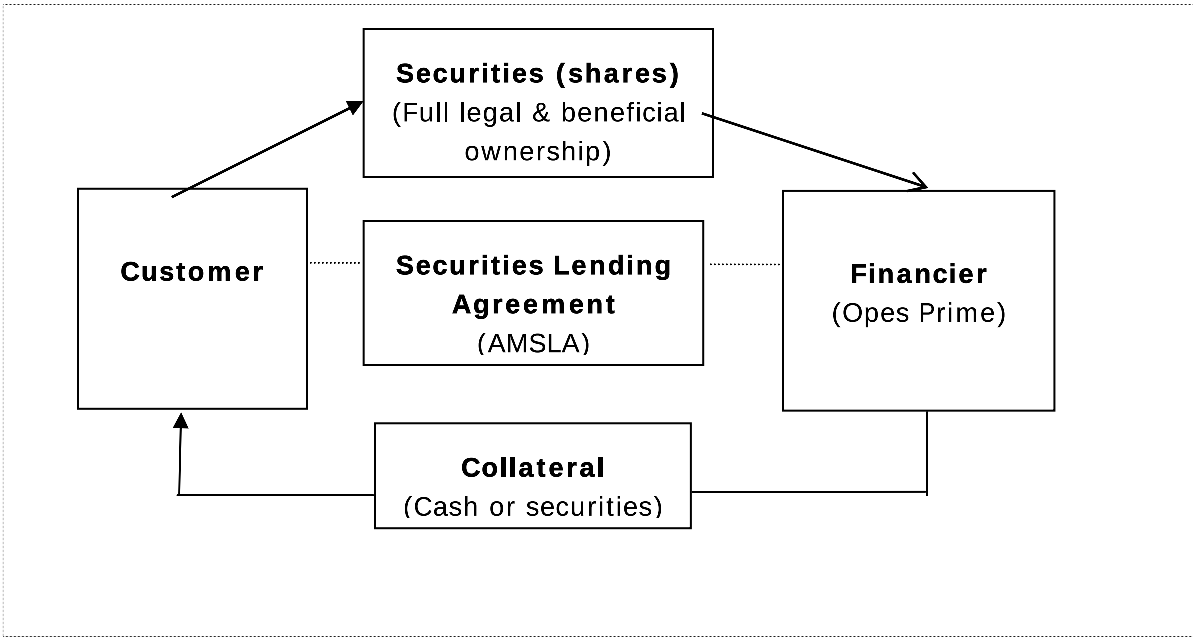
Opes Prime's business model

The equity finance transactions between Opes Prime and its customers were made under various securities lending and borrowing agreements based on an Australian Master Securities Lending Agreement (AMSLA). Those agreements provided the contractual basis upon which Opes Prime's customers transferred the legal and beneficial ownership of their securities to Opes Prime in exchange for cash collateral advanced to them by Opes Prime.

The amount of cash collateral provided by a financier is determined by a loan-to-valuation ratio (LVR), which generally reflects the financier's assessment of the quality of the securities being provided by the customer.

On a relatively low quality security, where the financier applied an LVR of, for example, 30 per cent, the financier would then provide cash to the customer equal to 30 per cent of the market value of the security. Where that position deteriorated, such as where the value of the securities fell, the financier could then make a 'margin call,' and the customer would be required to either transfer some additional securities or make payments to the financier in order to maintain the 30 per cent LVR.

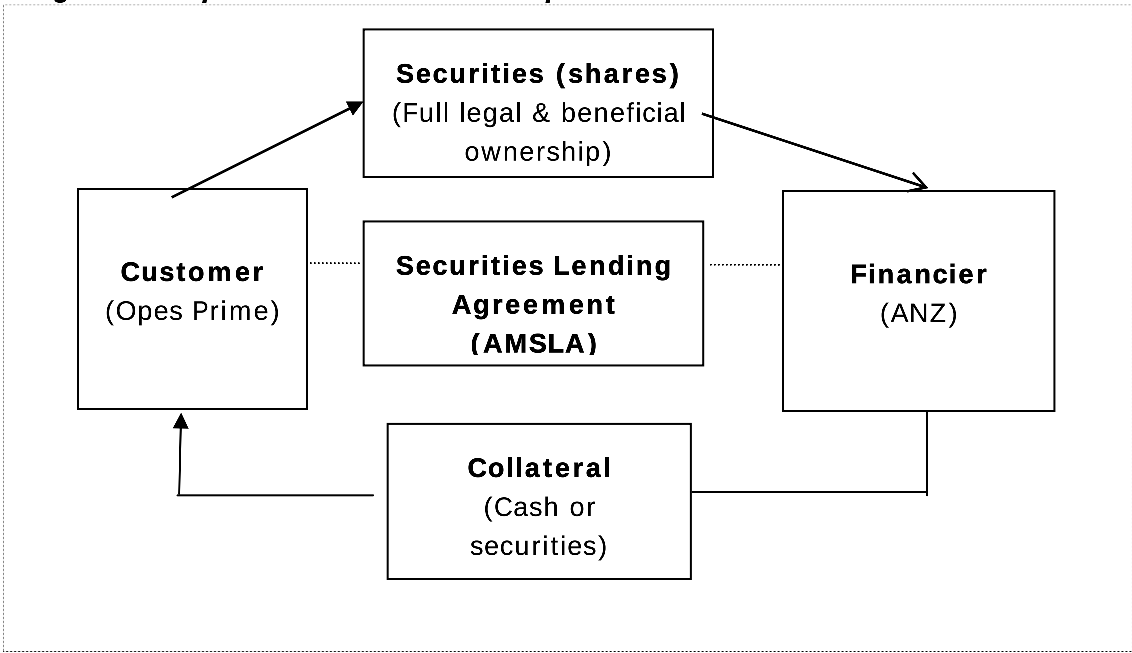
Diagram 1: Opes Prime's relationship with investors



In order to raise its own finance, Opes Prime itself entered into AMSLAs with a number of financiers including ANZ, Merrill Lynch and Dresdner Kleinwort. ANZ entered into two AMSLAs with Opes Prime companies, which ran for the duration of ANZ's relationship with Opes Prime.

Under those AMSLAs, Opes Prime would transfer securities to ANZ and in return ANZ would transfer to Opes Prime cash or other securities. ANZ would then return equivalent securities to Opes Prime upon repayment by Opes Prime of the cash or securities. The funds or securities available at any given time to Opes Prime, under the AMSLAs between it and ANZ, were based on an LVR model calculated on a daily basis.

Diagram 2: Opes Prime's relationship with ANZ



ANZ's role as financier to Opes Prime

ANZ's relationship with Opes Prime was limited solely to its role as financier, primarily through ANZ's securities lending and equity finance business. ANZ also provided some general banking facilities, including small working capital accounts, bank accounts and bank guarantees.

In respect of its dealings with Opes Prime, ANZ did not have any direct relationship with Opes Prime customers. ANZ was not party to the contracts between Opes Prime and its customers and, where securities were transferred to ANZ, ANZ was not provided with documents evidencing the identity of the person from whom Opes Prime obtained the relevant securities.

ANZ's knowledge of Opes Prime's customer base was necessarily limited given that ANZ did not have a direct relationship with Opes Prime's customers. Given that Opes Prime held legal and beneficial ownership of the securities, Opes Prime was not obliged to inform ANZ of the identity of the person from whom they had obtained the securities that it transferred to ANZ.

Since the collapse of Opes Prime, ANZ has come to understand that Opes Prime's customer base was diverse and included a wide range of customers. However, throughout ANZ's dealings with Opes Prime, Opes Prime consistently described its clients as high net worth individuals and sophisticated investors, as well as several stockbroking firms and fund managers.

ANZ also did not possess detailed knowledge of the way in which Opes Prime marketed its products, although Opes Prime stressed to ANZ that it did not provide financial advice, which was consistent with ANZ's then understanding of the sophisticated nature of Opes Prime's customer base.

Opes Prime's collapse

In early 2008, ANZ decided to tighten the management of the Opes Prime account by implementing a revised LVR model. Had it been immediately applied, the effect of the new LVR model would have been to place Opes Prime into a significant margin call.

Consequently, ANZ agreed that Opes Prime should set a timetable for an orderly migration to the new LVR model, with each milestone gradually reducing Opes Prime's potential margin call to ANZ. Opes Prime set the migration timetable (which extended over approximately two months) in accordance with agreed milestones. The first milestone was to be achieved by 12 March 2008.

Shortly before this date, ANZ was informed that Opes Prime could not in fact achieve the milestone. Consequently, on 13 March 2008, ANZ met with Opes Prime and explained that it sought increased comfort (broadly in the form of security and amendment to certain terms of the AMSLAs between ANZ and Opes Prime), pending a foreshadowed refinance of Opes Prime's facilities by Merrill Lynch. The basis for an agreement was reached, subject to Opes Prime Board approval.

ANZ next met with Opes Prime on 19 March 2008. ANZ understood that the purpose of the meeting was to discuss the issues raised on 13 March 2008. Instead, ANZ was unexpectedly informed by Opes Prime's directors that two serious issues had been uncovered:

- irregularities had been uncovered in respect of the account of one of Opes Prime's customers. ANZ was told that it appeared that Opes Prime's records had been manipulated to make it seem that the customer was within margin, when in fact this was not the case; and
- Opes Prime faced a request for redelivery by a customer of certain securities, valued at approximately $95 million. ANZ was told that the request required redelivery almost immediately. It was explained by the Opes Prime directors that the securities in question were lodged with ANZ and that Opes Prime did not have the funds to pay for the redelivery of those shares from ANZ.

ANZ was informed that without immediate assistance, the directors of Opes Prime would be required to appoint a voluntary administrator.

Given the urgency, ANZ prepared a plan to support Opes Prime. This plan ultimately included a loan of $95m to pay for the redelivery of the securities in question and a seven day 'stand-still' period in respect of margin calls. In return, ANZ sought the comfort it had discussed with Opes Prime on 13 March 2008, including the appointment of Deloitte as an investigative accountant to work with Ferrier Hodgson (Opes Prime's financial advisor) to assess the financial affairs and practices of Opes Prime.

ANZ also confirmed that - dependent on the outcome of the review by Deloitte and Ferrier Hodgson - a longer term work-out would likely be required over the following 6 to 12 months and that ANZ's preferred position was to reach a successful outcome for all parties. Opes Prime agreed to these terms and the documentation was executed on 20 March 2008.

Following 20 March 2008, Deloitte and Ferrier Hodgson commenced their investigative work. It soon became apparent that there were further issues and irregularities in Opes Prime's business.

On 27 March 2008 the directors of Opes Prime appointed Ferrier Hodgson to act as voluntary administrators. Later that day, given the appointment by Opes Prime of the voluntary administrators, ANZ appointed Deloitte as receivers and managers pursuant to a registered charge.

Impact on Opes Prime customers

While customers of Opes Prime are understood to have signed agreements providing for the transfer of ownership of securities, when a broker such as Opes Prime becomes insolvent, ANZ is seen to be, and in fact is, holding the securities that Opes Prime's customers may have expected would be returned to them. In realising these securities to protect its position, ANZ is regarded by some (including customers of Opes Prime) as acting in its own interests and at the expense of the customers of Opes Prime.

Some of Opes Prime's customers assert that they regarded their arrangements with Opes Prime as some form of margin lending. Some claim that they did not understand that theirs was a full transfer of legal and beneficial title in securities to Opes Prime, and that Opes Prime was then free to deal with these securities without restriction, including transferring them to ANZ.

On 2 May 2008, Justice Ray Finkelstein ruled in a test case in the Federal Court that Beconwood Securities, a customer of Opes Prime, did not have a legal claim to recover its shares under the AMSLA used by Opes Prime. His Honour upheld the effect of the Opes Prime securities lending agreement, finding that under the AMSLA:

- Full title to the shares passed; and
- The Opes Prime customer did not retain an equitable (beneficial) interest.

The fact Opes Prime sourced the securities from its clients was a key distinction between Opes Prime and other parties with whom ANZ entered into similar arrangements. The particular consequences to ANZ of this distinction were demonstrated following the appointment of administrators to Opes Prime. These included reputational consequences, which for ANZ arose primarily as a result of the position in which Opes Prime's customers found themselves. Upon the appointment of administrators to Opes Prime, its customers lost the ability to recall securities that they had transferred to Opes Prime, and instead became unsecured creditors for any 'netted' amounts owed to them under their Equity Finance arrangements with Opes Prime.

ANZ's response to the Opes Prime collapse

On 14 April 2008, ANZ's CEO announced a review of ANZ's involvement in Securities Lending and its dealings with Opes Prime. The key conclusions of the Review and remedial actions were announced publicly on 22 August 2008 in a report (attached) which can also be downloaded from www.anz.com.

The Review Committee found that at times there were deficiencies in the management of ANZ's Equity Finance business.

A comprehensive 13 point remediation plan has been developed to address the management control and accountability issues identified in the Review, including the departure of eight managers and executives from ANZ.

Implementing the remediation plan

In implementing its remediation plan, ANZ has reinforced four main values that it perceives as integral to conducting its business:

- encouraging individual accountability;
- improving risk culture;
- enhancing the importance of ethics in decisions and actions; and
- acting consistently with strategy.

To ensure that it acts in accordance with these values, ANZ has commenced implementation of the following measures:

- a complete and orderly withdrawal from all equity finance business and rationalisation of its standard securities lending businesses, so as to limit it to several key multinational institutional relationships;
- improving existing, and implementing new, control frameworks and processes, including:
  (i) improved Wholesale Credit Risk Policy;
  (ii) improved product approval processes;
  (iii) a new Reputation Risk Framework;
  (iv) a new Performance Management Framework;
  (v) improved controls around credit limits and customer exposure reporting; and
  (vi) entering into an enforceable undertaking with ASIC, in connection with its custody and securities processing business, ANZ Custodian Services.

Progress on the 13 point remediation plan has been closely monitored by the Australian Prudential Regulation Authority (APRA), which has identified that ANZ has made good progress in addressing the various issues raised. Of those 13 items, APRA considers that six are closed, one is partially closed and a further five items are currently being reviewed by APRA for closure. The remaining item is currently undergoing review at ANZ before completion and submission to APRA.

In accordance with the enforceable undertaking between ANZ and ASIC, a remediation plan undertaken in ANZ Custodian Services will be reviewed by an appointed independent expert.

In order to ensure that this process is implemented fully, ANZ has worked with its regulators to implement the remediation items and has kept its regulators informed of developments.

Finally, ANZ has reached agreement with the liquidators of Opes Prime for the implementation of a scheme of arrangement between ANZ, Merrill Lynch and Opes Prime and various other related parties and creditors. Agreement was reached following multi-party talks, which were mediated by a former Justice of the Court of Appeal, the Honourable Alex Chernov AO QC. The scheme of arrangement was approved, first by the creditors of Opes Prime, and finally by Justice Ray Finkelstein on 4 August 2009. The scheme will provide Opes Prime's creditors with a significant return on the amounts owed to them by Opes Prime, as a result of ANZ and Merrill Lynch contributing to a settlement figure in excess of $250 million.

Observations on the existing regulatory regime

ANZ is not aware of any evidence that the collapse of Opes Prime stemmed from any deficiency in the regulatory framework. To ANZ's knowledge, the directors of Opes Prime were highly experienced in the business of securities lending and equity finance. Each of the directors had worked for many years in the industry.

For its part, although ANZ did not have any direct dealings with the customers of Opes Prime, ANZ recognises that at times there were deficiencies in the management of its equity finance business.

4. STORM FINANCIAL

Following a two month review, ANZ has currently identified around 160 of our customers who may have borrowed from ANZ to invest through Storm Financial. We have also been working cooperatively with ASIC to provide assistance and information for its review of the collapse of Storm Financial.

Review Methodology

Our review team analysed the lending files of the identified customers to assess the quality of the credit decisions and whether they accorded with ANZ's credit policies at the time. We are keeping ASIC apprised of the review process and its findings.

Key Findings

(i) Customers

The review found that the lending was predominantly by way of home loans secured against property. There were also a small number of personal loans and business loans, which we are reviewing to determine whether they were used for Storm investments. ANZ did not provide margin loans to these customers. Of these loans we have determined that, in some cases, the lending decisions did not comply with ANZ's credit policies.

Following the review of the 160 customer files, we have determined that the lending decisions for a small number of customers did not comply with ANZ's credit policies and we are undertaking further review to assess whether others could also be in that group.

(ii) ANZ's relationship with Storm

The review also identified that these were isolated cases and not part of a formal relationship with Storm Financial. At no time did ANZ have a formal relationship with Storm.

ANZ was approached by Storm in November 2007 seeking a formal referral arrangement. ANZ declined on the basis that the Storm 'business model' was not compatible with ANZ's approach to lending. For example, Storm's preferred approach was that Storm representatives would:

- explain the bank's lending documentation to customers;
- provide the bank with instructions regarding a customer's account maintenance (i.e. renewals);
- would arrange for the customer's 100 point identification check to be completed; and;
- expect the bank to provide a quote for a customer's lending requirements prior to a full application having been submitted.

On the basis that these requirements were unacceptable to ANZ, it was agreed that ANZ could not work with Storm.

Remedial and accountability actions

We are in the process of contacting those customers who we have identified in our review where our lending policies were not followed correctly.

1. Fair and appropriate treatment

Where it is established that there has been non-compliance with ANZ policies and procedures in lending to these customers we will call these customers and ensure they are treated appropriately and fairly. Our approach will include assessing financial hardship on a case-by-case basis having regard to their individual circumstances and rectifying financial detriment that directly resulted from any action on ANZ's part. This resolution could include, for example, reassessing the amount ANZ would have lent if policies had been adhered to; waiving interest or restructuring the loan to be interest free or reducing the loan amount.

In addition, we are writing to all other customers we have identified to date, to whom we lent and who were also Storm investors, to invite them to contact ANZ on our toll-free number (1800 280 543) should they wish to discuss their financial circumstances relating to Storm. We have a team dedicated and trained to be able to make arrangements quickly and efficiently over the phone wherever possible and where the customer agrees.

2. Dedicated Storm Hardship Team

We have established a single point of contact in our Hardship Team for affected customers to ensure their contact with ANZ is managed by someone familiar with the detail of the cases involved and can provide appropriate information. Escalation to ANZ's internal Customer Advocate is available. The Customer Advocate operates at arm's length to ANZ's business and reports to the Australian CEO. If the case is not resolved to the customer's satisfaction, we will make available an independent external arbitrator at no cost to the customer.

3. Hardship Commitments and options

Where Storm customers are in hardship we have a range of non-traditional repayment options available including:

- repayment deferral with interest waived for the period of the deferral; and
- in special circumstances an interest free loan or reduced loan amount.

We are aware of the hardship experienced by some Storm customers and we have given an assurance that ANZ will seek to work with Storm customers to find solutions to keep them in their homes.

FEDERAL COURT OF AUSTRALIA

Beconwood Securities Pty Ltd v Australia and New Zealand Banking Group Limited [2008] FCA 594

CONTRACT – securities lending agreement – contract to lend shares – ownership of shares – whether securities lending agreement constitutes secured loan or purchase-and-sale – whether reference may be had to economic effect of transaction in determining legal character – whether contract is to be construed with reference to its purpose, background, context, and market – whether same contract may be construed differently if entered into in different market or by different participants – implied term – whether it is reasonable and equitable to imply a term requiring shares acquired to be held and retained

CORPORATIONS – whether administrator or receiver is analogous to liquidator

EQUITY – claim for equitable interest in shares transferred on documents purporting to give full title to broker – whether equity of redemption can exist after outright transfer of title – whether equitable charge over undefined shares may exist absent appropriation

WORDS AND PHRASES – charge – credit risk – margin – mortgage – repo – securities lending

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BECONWOOD SECURITIES PTY LTD and BECONWOOD LIMITED v AUSTRALIA AND NEW ZEALAND BANKING GROUP LIMITED, OPES PRIME STOCKBROKING LTD (RECEIVERS AND MANAGERS APPOINTED) (ADMINISTRATORS APPOINTED), SALVATORE ALGERI, CHRISTOPHER CAMPBELL and ANZ NOMINEES LIMITED

VID 206 of 2008

FINKELSTEIN J
2 MAY 2008
MELBOURNE

GENERAL DISTRIBUTION

IN THE FEDERAL COURT OF AUSTRALIA

VICTORIA DISTRICT REGISTRY **VID 206 of 2008**

BETWEEN:	**BECONWOOD SECURITIES PTY LTD and BECONWOOD LIMITED** **Plaintiffs**
AND:	**AUSTRALIA AND NEW ZEALAND BANKING GROUP LIMITED,** **OPES PRIME STOCKBROKING LTD (RECEIVERS AND MANAGERS APPOINTED) (ADMINISTRATORS APPOINTED),** **SALVATORE ALGERI,** **CHRISTOPHER CAMPBELL and** **ANZ NOMINEES LIMITED** **Defendants**

JUDGE:	**FINKELSTEIN J**
DATE OF ORDER:	**2 MAY 2008**
WHERE MADE:	**MELBOURNE**

THE COURT ORDERS THAT:

The question stated under O 29 of the *Federal Court Rules 1979* (Cth) be answered as follows:

Question: "Does a Lender of Securities 'loaned' to a Borrower under the Securities Lending and Borrowing Agreement (SLA) have an equity of redemption or other equitable estate or equitable interest in those Securities or in Equivalent Securities immediately upon or after the 'loan' of those Securities by the Lender to the Borrower?" (For purposes of this question, the expressions "Borrower", "Equivalent Securities", "Lender" and "Securities" have the meaning given to them in cl 22 of the SLA.)

Answer: "No".

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JUDGE:	**FINKELSTEIN J**
DATE:	**2 MAY 2008**
PLACE:	**MELBOURNE**

REASONS FOR JUDGMENT

The Dispute

1 The importance of this case is evident from the number of claims dependent upon its resolution. However, the question in issue in this hearing is only one of several that arise in the dispute between the plaintiffs, Beconwood Securities Pty Ltd and Beconwood Ltd (collectively Beconwood), their broker, the second defendant, Opes Prime Stockbroking Ltd (Receivers and Managers appointed) (Administrators appointed) (OPS) and one of its bankers, the first defendant, Australia and New Zealand Banking Group Ltd (ANZ). The question involves the construction of an agreement, entitled "Securities Lending and Borrowing Agreement" (SLA), that was entered into between Beconwood and OPS. Under that agreement Beconwood transferred shares to Green Frog Nominees Pty Ltd, a company related to OPS, in return for funds. The funds advanced to Beconwood were obtained from ANZ. In due course the shares held by Green Frog were transferred to the fifth defendant, ANZ Nominees Ltd, and held for ANZ.

2 Beconwood contends that it has a security interest in the shares still held by ANZ Nominees. It founds this contention on a number of bases, only two of which are presently relevant. First Beconwood says that, on its true construction, the legal effect of the SLA is to create a mortgage of its shares in favour of OPS with the consequence that the shares can be redeemed on repayment of the money received from OPS. The second basis is that Beconwood has an equitable charge over the shares. If it is successful on either count Beconwood says that its interest as mortgagor or chargee (as the case may be) has priority over ANZ's legal title. (For purposes of determining priority ANZ is to be treated as holding the legal estate: *Macmillan Inc v Bishopsgate Investment Trust Plc* (No 3) [1995] 1 WLR 978, 1001.) Whether Beconwood's claimed equitable estate has priority over ANZ's legal estate will, if necessary, be decided on another day.

Securities Lending

3 By way of background, it is appropriate to say something about the business of securities lending. The description that follows is derived from a variety of sources, including: C Benjamin, *Interests in Securities: A Proprietary Law Analysis of the International Securities Markets* (2000); K Tyson-Quah (ed), *Cross-Border Securities: Repo, Lending and Collateralisation* (1997); F J Fabozzi (ed), *Securities Lending & Repurchase Agreements* (1997); F J Fabozzi & S V Mann (eds), *Securities Finance: Securities Lending and Repurchase Agreements* (2005); P Ali, *The Law of Secured Finance: An International Survey of Security Interests over Personal Property* (2002); M C Faulkner, "An Introduction to Securities Lending" (Spitalfields Advisors report, 3rd ed, 2006); M J Fleming & K D Garbade, "The Specials Market for US Treasury Securities and the Federal Reserve's Securities Lending Program" (Federal Reserve Bank of New York draft working paper, 28 August 2003); Technical Committee of The International Organization of Securities Commissions, "Securities Lending Transactions: Market Development and Implications" (International Organization of Securities Commissions and Bank for International Settlements report, July 1999); G M D'Avolio, "Essays in Financial Economics" (PhD thesis, Harvard University, September 4 2003); affidavit of Natalie Floate, Chairman of the Australian Securities Lending Association (ASLA).

4 Securities lending refers to the practice by which securities are transferred from one party (the lender) to another party (the borrower), with the borrower contractually obliged to

redeliver to the lender at a later time securities which are equivalent in number and type. Securities lending is an important element of modern financial markets, playing a substantial role in promoting market liquidity and providing stability to securities settlement systems. Although the practice can be traced back to the 19th century, an active market for securities lending did not emerge until the 1960s. The market developed principally to accommodate two growing needs: first, to avoid settlement failure (stock market transactions had to be settled within a short period) and, secondly, to accommodate short selling (the practice of selling shares that the seller does not currently own in the hope of buying them in at a lower price and in the meantime acquiring shares to complete the sale). Securities lending was also spurred by more sophisticated forms of trading strategies, often involving derivatives, which require borrowed stock. For example, traders in equity options, indexed futures, equity return swaps and convertible bonds began selling short to either hedge their positions or exploit arbitrage opportunities.

5 The modern securities lending market can, broadly speaking, be divided into two markets, one that is defined by the motive of the borrower (the "securities driven" market) and the other by the motive of the lender (the "cash driven" market). In the first category, which is the more common type of transaction, a borrower seeks access to specific securities, usually to cover exposure to a short position. In the second category, a lender of securities seeks access to cash, often for purposes of equity financing at interest rates which are better than the uncollateralised borrowing rate.

6 Securities lending is typically structured in one of three ways: securities loan transactions, repurchase agreements and sell-buyback arrangements. While the legal forms of the transactions differ, the commercial purposes are the same. In a securities loan transaction in the securities driven market the lender transfers specific securities to the borrower who must return "equivalent securities" to the lender either on demand, on the occurrence of a defined event or at the end of an agreed term. The borrower: (1) obtains an outright transfer of title to the securities, which may then be sold or on-lent; (2) pays a fee for the use of the securities, calculated by reference to the value of the lent securities; and (3) provides collateral to the lender in the form of cash, other securities or other assets (eg government bonds, certificates of deposit, bank letters of credit), title to which passes to the lender. The value of the collateral exceeds the value of the borrowed securities, the

difference in percentage terms being referred to as the "margin". At the conclusion of the transaction there is an exchange of "equivalent securities" for "equivalent collateral". In the event of default provision is made for placing a money value on each party's obligations, setting one off against the other, and, if there is a net balance, for payment of the balance. A securities loan in the cash driven market follows the same structure but with important differences. First, the collateral is always provided in the form of cash. Secondly, the amount of cash collateral is less than the value of the lent securities. And thirdly, the lender pays a fee, much like interest, calculated by using a discounted interest rate. By reason of these differences commentators and securities lending participants colloquially refer to the securities rather than the cash as the collateral.

7 In a repurchase agreement (called a "repo"), the seller agrees to transfer securities to the buyer in exchange for a transfer of cash and the buyer of the securities agrees to sell back the same or equivalent securities at a different price on a future date. There are two kinds of repos: a general collateral repo and a special collateral repo. A general collateral repo, in which the seller is after cash and the buyer seeks securities of sufficient value as collateral, is a transaction in the cash driven market. The seller compensates the buyer for the use of the cash during the term of the repo by the differential (which essentially reflects a rate of interest) as well as by the securities being priced at below market. A special collateral repo, in which the buyer is after specific securities, is a transaction in the securities driven market. The buyer pays compensation by the securities being priced at above market. In a sell-buy back transaction, the sale and buy trades are entered into at the same time but the buy back settlement date is fixed at some future point.

Risk

8 It should come as no surprise to the reader to learn that there are risks for those who participate in securities lending. The risks include: liquidity risk (counterparty not settling an obligation on time, often due to the inability to obtain securities for redelivery), market risk (adverse movements in the market price of assets), legal risk (unexpected application of a law or the inability to enforce a contract), operational risk (deficiencies in information systems or internal controls), settlement risk (completion or settlement of transactions failing), credit risk (counterparty not settling an obligation in full, either when due or at any time thereafter, often as a consequence of insolvency), principal risk (the primary form of

credit risk that arises where either the securities or collateral are not delivered) and replacement cost risk (the secondary form of credit risk that arises where the non-defaulting party incurs costs in realising the value of assets).

9 In this case credit risk is all important. Boiled down to its essence, a party's exposure to loss in the event of default is equal to the margin. That is to say, if the non-defaulting party is on the short side of the margin (ie the value of the assets delivered to him is less than the value of the assets provided) he will suffer a loss and, in the case of insolvency, be required to prove for the difference in the insolvency of the defaulting party.

10 It is worthwhile pointing out that in other jurisdictions there is a regulatory and statutory framework that provides a measure of protection to investors that is lacking in Australia. In the United States, for example, the credit risk faced by parties is mitigated by a variety of provisions. First, the Securities and Exchange Commission (SEC) "strictly regulates the solvency and practices of registered broker-dealers pursuant to the Securities Exchange Act [SEA] of 1934": J Schroeder, "Repo Madness: The Characterization of Repurchase Agreements under the Bankruptcy Code and the UCC" (1996) 46 *Syracuse Law Review* 999, 1041. Second, the conduct of brokers and, more specifically, the claims of investors in the event of a broker's insolvency, are governed by the Securities Investor Protection Act 1970 (US) (SIPA): see generally R Hakes, "UCC Article 8: Will the Indirect Holding of Securities Survive the Light of Day?" (2003) 35 *Loyola of Los Angeles Law Review* 661, 734-741; Schroeder at 1037-47; D Morse, "When a Securities Brokerage Firm Goes Broke: A Primer on the Securities Investment Protection Act of 1970" (2006) 25(2) *American Bankruptcy Institute Journal* 34.

11 SIPA established a quasi-governmental organisation known as the Securities Investor Protection Corporation (SIPC). The SIPC has power to liquidate insolvent broker-dealers under SIPA (rather than under the Bankruptcy Code) and effectively insures certain investor claims for up to $500,000 per account: Schroeder at 1040. Although the SIPC has taken the position that creditors of insolvent brokers under securities lending agreements are not covered by its bail-out scheme, some courts have held otherwise: Schroeder at 1043-1046. The case law on this point is somewhat sparse, however, in part because of the success of the regulatory oversight scheme: Schroeder at 1041 (noting that out of 20,344 broker failures

between 1970 and 1992, only 228 required the SIPC to step in to cover investor claims and that "[a]s a result, there is remarkably little reported case law" interpreting the relevant provisions). Although a SIPA liquidation is generally similar to a liquidation under the Bankruptcy Code, one interesting difference is that, unlike in a liquidation under the Bankruptcy Code, under SIPA the SIPC has the power to stay the set-off provisions of a securities lending agreement that would otherwise liquidate to a single sum the obligation of a broker in insolvency to redeliver equivalent securities. Instead, SIPA gives the SIPC the option, where feasible, to direct the trustee in liquidation to redeliver the equivalent securities, whether by purchasing them on the market or otherwise: Morse at 71.

12 The net effect of the regulatory framework is that although a US securities lender may still be unsecured as to any difference in value between the cash obtained from the broker and the value of the securities provided, the risk is much less. Due to strict regulatory oversight of the broker, the lender can have some confidence that the broker will not suddenly fail (or, alternatively, that the SEC and SIPC will have notice before failure occurs and be able to address the situation before matters reach the stage they have in this case): Schroeder at 1041 ("The stringent reporting and auditing requirements of [the SEA] have been a successful early warning system which has allowed the SEC and SIPC to step in quickly and sell troubled broker-dealers' customer business to solvent broker-dealers before it is too late"). The lender might also not unreasonably expect that he will be at least partially bailed out by the government even if the broker does fail. In other words, part of the answer to the credit risk problem may be that it is in fact not as much of a problem in other jurisdictions.

Standard Agreements

13 By virtue of the significant increase in securities lending in the last several decades, standard documentation has been developed by leading trade associations. Of importance to this case is the Overseas Securities Lending Agreement (OSLA) which was superseded by the Global Masters Securities Lending Agency (GMSLA), both prepared by the International Stock Lenders Association, based in London. OSLA was (and GMSLA is) intended to govern all securities loan transactions, that is, the transaction structure is used interchangeably for a borrower who is after specific securities and a lender who is seeking cash. In 1996 ASLA commissioned Messrs Mallesons Stephen Jacques to adapt OSLA for

the Australian market. The resultant agreement, released in April 1997, is known as the Australian Masters Securities Lending Agreement and is often referred to as "AMSLA".

14 The term "securities lending" under these agreements is factually incorrect. The transaction that is referred to as "lending" is in terms an outright disposal of the securities lent, linked to a subsequent acquisition of equivalent securities. In other words the agreements provide that title to the securities on loan, as well as to any collateral that is received by the lender, passes from one party to the other. On the other hand, the economic benefits of ownership are "manufactured" back to the lender by the terms of the securities loan agreements.

Background of Dispute

15 For purposes of the issue presently to be determined, Beconwood came into the picture in the following circumstances. In October 2006, Beconwood's director, Mr Choiselat, instructed Ms Chan, the office manager, to investigate "margin lending facilities on small market cap stocks." Ms Chan then met with an OPS employee in late October to discuss the possibility of Beconwood establishing a facility with OPS in order to leverage its holdings in Destra Corp Ltd, Q Ltd, and Jumbuck Entertainment Ltd, each a publicly listed company. No agreement was reached but Ms Chan revisited the issue of a lending facility with OPS at another meeting on 17 July 2007. In addition to the meetings, the parties also exchanged email correspondence regarding the proposed facility.

16 I emphasise that for present purposes it is neither necessary nor proper to consider (and I expressly have not considered) precisely what representations were or were not made in the meetings and correspondence between Beconwood and OPS, or what Beconwood may or may not have understood regarding the meaning of the terms of the proposed securities facility. At present, it necessary only to note that Beconwood entered into the SLA, the construction of whose written terms is now at issue, shortly after the 17 July meeting, with Beconwood Securities entering the SLA on 31 July 2007 and Beconwood Ltd entering on 16 August 2007.

17 Pursuant to the SLA, Beconwood Securities transferred to Green Frog at the direction of OPS 1,116,355 shares in Q on 31 July 2007 and 1,559,447 shares in Jumbuck on 13

November 2007. Beconwood Ltd transferred to Green Frog at the direction of OPS 10,962,104 shares in Destra on 16 August 2007, a total of 114,463,651 shares in Q on four dates between 16 August 2007 and 8 January 2008, and 2,000,000 shares in Jumbuck on 4 December 2007. The total market value of the shares transferred by Beconwood was said by counsel for Beconwood to be approximately $7 million, presumably calculated just prior to the appointment of receivers to, and administrators over, OPS. An examination of the share price tables on the ASX website bears this out. In return for the shares Beconwood received from OPS cash in the amount of $1,353,830.02.

18 On or shortly after the day of each transfer to Green Frog, the shares were transferred to ANZ Nominees. Mr Cahill, the head of the financial institution products division of ANZ, stated that ANZ Nominees acquired the shares as "custodian and nominee" for ANZ. The transfers were effected pursuant to a modified AMSLA between OPS and ANZ dated 26 July 2006. It is the shares still held by ANZ Nominees that are the subject of Beconwood's claim.

The Securities Lending Agreement

19 The SLA is based largely on AMSLA. The following provisions are important.

20 In the description of the parties Beconwood is identified as the "Client".

21 Clause 1.1 provides that "[t]he lender will lend Securities to the Borrower, and the Borrower will borrow Securities from the Lender, in accordance with the terms of this Agreement." The definitions of "Lender" and "Borrower" in cl 22 indicate that Beconwood and OPS may be either a "Borrower" or a "Lender". In all cases, cl 1.1 requires that OPS has received from the Client a "Borrowing Request". The definition of the "Borrowing Request" in cl 22 states that the request (which may be oral or in writing) must, among other things, describe the Securities to be lent, and the amount of any collateral.

22 Clause 1.1 also provides that if OPS is the Borrower, Beconwood must pay a Fee which "initially will be interest on the Cash Collateral". Cash Collateral is defined in cl 22 as "Collateral that takes the form of a payment of currency".

23 Clause 3.1 provides: "The Parties must execute and deliver all necessary documents and give all necessary instructions to procure that all right, title and interest in [any Securities, Equivalent Securities, Collateral or Equivalent Collateral] will pass absolutely from one Party to the other, free from all liens, charges, equities and encumbrances, on delivery or redelivery of the same in accordance with this Agreement."

24 Clauses 3.2 and 3.3: These clauses may be summarised as giving the Lender the right to dividends, and other benefits which it would be entitled to were a securities lending transaction not to have taken place. As applied to the facts of this case, the clauses attempt to "manufacture" for Beconwood a contractual equivalent to the beneficial interest it would have retained had it not transferred shares to Green Frog.

25 Clause 3.4 provides: "Notwithstanding the use of expressions such as "borrow", "lend", "Collateral", "Margin", "redeliver", etc., which are used to reflect terminology used in the market for transactions of the kind provided for in this Agreement, all right title and interest in and to Securities "borrowed" or "lent" and "Collateral" which one Party transfers to the other in accordance with this Agreement will pass absolutely from one Party to the other free and clear of any liens, claims, charges or encumbrances or any other interest of the Transferring Party or of any third party (other than a lien routinely imposed on all securities in a relevant clearance system) without the transferor retaining any interest or right to the transferred property, the Party obtaining such title being obliged only to redeliver Equivalent Securities or Equivalent Collateral, as the case may be. Each Transfer under this Agreement must be made so as to constitute or result in a valid and legally effective transfer of the Transferring Party's legal and beneficial title to the recipient." Clause 3.4 is buttressed by the warranty of the Lender (ie Beconwood) in cl 9(c) that it is "absolutely entitled to pass full legal and beneficial ownership of all Securities" to the Borrower (ie OPS) free from "all liens, charges, equities and encumbrances."

26 Clause 4.1 also picks up the obligation to pay a fee. It provides that if in respect of a loan of securities the Collateral is cash, the Collateral Taker must pay "a fee … in respect of the amount of that Collateral, calculated at the rate initially as agreed" and "the Client must pay a fee to Opes Prime for each loan of Securities" in an amount agreed.

27 Clause 5 deals with Collateral and top-up Collateral. The heading to cl 5.1 reads: "Borrower's Obligation to Provide Collateral". According to its terms, however, the clause only imposes the obligations to provide Collateral and top-up Collateral on "[t]he Client as Borrower or Lender". Clause 5.2(a)(i) states that the "aggregate value of the Collateral delivered to or deposited with Opes Prime … [must] be at least the aggregate of the Required Collateral Value". Clause 5.2(a)(ii) states that the "[i]f the aggregate value of the Posted Collateral … exceeds the aggregate of the Required Collateral Value … Opes Prime must (on demand) repay such Cash Collateral or redeliver to the Client Equivalent Collateral". These subclauses operate so that if the value of the securities transferred by the Client relative to the amount of cash transferred by OPS drops below a certain predetermined ratio (variously called the Required Collateral Value, Loan-to-Value ratio or LVR), the Client will be required to transfer additional securities. If the converse occurs and the value of the securities increases OPS must redeliver equivalent securities to eliminate the excess.

28 Clauses 6.1 and 6.2: These clauses require the Borrower "to redeliver Equivalent Securities in accordance with this Agreement and the terms of the relevant Borrowing Request" and specifically at the call of the Lender. Equivalent Securities are defined in cl 22 to be "securities of an identical type, nominal value, description and amount to particular Securities borrowed and such term will include the certificate and other documents of or evidencing title and transfer". The definition goes on to provide that in redelivering Equivalent Securities, one must also factor in the value, in cash or kind, of corporate events affecting the value of the Securities, such as splits, dividends, takeovers, redemptions and so forth.

29 Clause 6.3 permits the Lender to terminate the loan of Securities upon written notice if the Borrower fails to redeliver Equivalent Securities as requested, in which case the netting provisions of clause 7 are triggered.

30 Clause 7: This clause provides for netting (ie acceleration and reduction to a single sum certain) as well as set-off of the parties' obligations against each other in an Event of Default and also in a case where the Borrower has failed to redeliver Equivalent Securities under cl 6.3.

31 Clause 11.1 defines Events of Default to include (in cl 11.1(d)) an "Act of Insolvency" by either party. Clause 22 in turn relevantly defines an Act of Insolvency to include appointment (or attempt, consent, or acquiescence to appointment) "of any trustee, administrator, receiver or liquidator or analogous officer," or the presentation of a petition or other attempt to wind up or liquidate. Most Events of Default require a notice to be given to trigger netting. In the event of "the appointment of a liquidator or analogous officer" netting is automatic: cl 11.1(d).

32 Clause 16 provides: "Each Party agrees that, in relation to legal proceedings, it will not seek specific performance of the other Party's obligation to deliver or redeliver Securities, Equivalent Securities, Collateral or Equivalent Collateral, but without prejudice for any other rights it may have."

33 The assumption that lies behind cls 1.1 and 4.1, as well as other provisions, is that Beconwood will lend securities to OPS and, in return, will receive cash collateral. It is also assumed that Beconwood may be required to top up the value of the lent shares (by lending more shares) to maintain the margin. There is, however, no provision in the SLA that imposes an obligation on OPS to provide collateral. Nor is there a provision that requires Beconwood to provide additional shares. Perhaps the draftsman assumed that cl 5 would satisfy both functions. But when read literally it does neither.

34 This is a serious gap. Interestingly, this defect does not appear in cl 6 of AMSLA from which cl 5 has been adapted. Be that as it may, the SLA does contemplate that the parties will (indeed they must) reach independent agreement on a number of matters including the type of securities Beconwood is to lend to OPS, the value of the cash collateral that will be delivered to Beconwood and the margin that is to apply. That is precisely what happened. Although not all the evidence is before the court, it is sufficiently clear that, in correspondence and conversations between Beconwood and OPS, they agreed on the identity of the shares to be lent, on the amount of cash collateral and on the margin. To the extent that it is necessary to give cl 5 any operation, it will be to require Beconwood to deliver top-up securities. This can be achieved by treating the expressions Cash Collateral and Collateral as references to the lent shares. Even if this is not how cl 5 operates the problem with the clause will not affect the outcome of this application. One reason is the severance provision in

cl 15, which provides that the balance of the SLA should remain effective even if one clause is void or unenforceable. Another reason is that the question in issue does not involve any matters that might even arguably turn on cl 5, such as a dispute as to the provision of collateral or the maintenance of the loan to value ratio. Rather, the question here involves only the ownership of the lent securities.

The Claim

35 Beconwood claims that the true character of the SLA is that of a mortgage pursuant to which it borrowed money from OPS and put up its shares by way of security. It follows, so the argument goes, that Beconwood has an equity of redemption in respect of those shares. Its alternative argument is that by reason of the SLA Beconwood has a charge over the shares which is enforceable in equity. The corollary of each argument is that under the arrangement OPS did not become the absolute owner of the shares.

Security Interests

36 Under Australian law there are only four kinds of proprietary interest by way of consensual security, namely a pledge, contractual lien, equitable charge and mortgage: *Re Cosslett (Contractors) Ltd* [1998] Ch D 495, 508; see also R M Goode, *Legal Problems of Credit and Security* (3rd ed, 2003) at 1-42. In the way this case was argued, we are only concerned with a mortgage and a charge.

37 A mortgage is "a security created by contract for the payment of a debt already due or to become due, or of a present or future advance, effected by means of an actual or executory conveyance of real or personal property, charging the mortgaged property with the payment of the money secured": *Coote on Mortgages* (9th ed, 1927) vol 1 at 6. A mortgage may be legal or equitable. A legal mortgage involves an assignment or transfer of property to the mortgagee: *Santley v Wilde* [1899] 2 Ch 474. There will be a mortgage in equity if there is an agreement to grant a legal mortgage. The right of the mortgagee in equity is to have his security perfected, usually by the execution of a legal mortgage: *Matthews v Gooday* (1861) 31 LJ Ch 282. By way of example, the delivery of share certificates with blank transfers will create an equitable mortgage of the shares: *Harrold v Plenty* [1901] 2 Ch D 314, 316. The

mortgage will become a legal mortgage when the transfers are registered: *Rose v Inland Revenue Commissioner* [1952] 1 Ch D 499, 510-511.

38 A charge differs from a mortgage because it does not depend upon a transfer of the ownership of the charged property. It is of the essence of a charge that a particular asset or class of assets is appropriated to the satisfaction of a debt or other obligation of the chargor, or a third party, so that the chargee is entitled to look to the asset and its proceeds for the discharge of the liability: *Re Cosslett* [1998] Ch D at 508. A charge can arise by operation of law or by agreement. A charge may be fixed, that is, attached to particular assets which are identified or ascertainable. Or a charge may relate to a changing class of present and future assets and not attach to any particular asset unless it is converted to a fixed charge. In the case of a fixed charge, the chargor cannot dispose of the assets without the chargee's consent, but the chargor can in the case of a floating charge.

Principles of Construction

39 For purposes of deciding whether the SLA created either a mortgage over Beconwood's shares in favour of OPS or a charge over those shares in favour of Beconwood, I propose to state, briefly, the principles of construction that I intend to apply.

40 The task is to discover the true substance of the transaction. On this aspect I will proceed, so far as this trial is concerned, on the basis that the SLA is a true record of the arrangement between Beconwood and OPS and that it is no sham or artifice to disguise their true intention. It must be remembered, however, that Beconwood contends that if it has not made out its case on the SLA alone, it will still be able to do so when account is taken of representations allegedly made by OPS and which form part of the arrangement, or inform that arrangement. At this point I am only concerned with the effect of the SLA without regard to any wider aspects of the arrangement. In particular, I need not consider whether Beconwood could lead extrinsic evidence regarding the effect of the SLA absent some ambiguity in its terms or in support of an attack that the SLA is a sham.

41 On this basis the character of the SLA must be determined from its language, particularly of its operative parts. If those provisions are clear, they must be given effect, unless there are provisions which alter that effect. In *McEntire v Crossley Brothers Ltd*

[1895] AC 457 (described by the High Court in *Associated Alloys Pty Ltd v ACN 001 452 106 Pty Ltd (in liq)* (2000) 202 CLR 588, 606 as one of the "basic authorities in commercial law"), Lord Herschell said (at 463):

> [T]here is no such thing, as seems to have been argued here, as looking at the substance [of the agreement], apart from looking at the language which the parties have used. It is only by a study of the whole of the language that the substance can be ascertained.

Similarly Lord Watson said (at 467):

> [T]he substance of the agreement must ultimately be found in the language of the contract itself. The duty of a Court is to examine every part of the agreement, every stipulation which it contains, and to consider their mutual bearing upon each other; but it is entirely beyond the function of a Court to discard the plain meaning of any term in the agreement unless there can be found within its four corners other language and other stipulations which necessarily deprive such term of its primary significance.

Much the same was said in *Helby v Matthews* [1895] AC 471, 475 and *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1, 20.

42 What this means is that the character of a transaction is to be determined by reference to its legal nature, not to its economic effect. The leading authority on this point is the advice of Lord Devlin in *Chow Yoong Hong v Choong Fah Rubber Manufactory* [1962] AC 209. He said (at 216-217): "There are many ways of raising cash besides borrowing. … If in form it is not a loan, it is not to the point to say that its object was to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money."

43 I propose also to apply the rule that a commercial contract should be construed having regard to its purpose, which requires an understanding of the genesis of the transaction, its background, its context, and the market in which the parties are operating: *Codelfa Construction Pty Ltd v State Railway Authority (NSW)* (1982) 149 CLR 337, 350 applying *Reardon Smith Line Ltd v Hansen-Tangen* [1976] 1 WLR 989, 995-996. See also *Pacific Carriers Ltd v BNP Paribas* (2004) 218 CLR 451. The controversy here is in identifying what is the appropriate context and what is the relevant market.

44 The SLA is derived from AMSLA which in turn is derived from OSLA. Both OSLA's successor GMSLA and AMSLA are in widespread use in markets (both cash driven and securities driven) in which the participants give or take an outright transfer of securities in exchange for a promise that the borrower will deliver equivalent securities or that the redelivery obligation will be set off against the duty to return collateral in the event of default.

45 The principal objects of securities driven share lending (to enable the borrower to satisfy a short sale or to complete the settlement of a sale within the time) can only be achieved by transferring title to the borrowed securities to the borrower. This is the very essence of the transaction; without the ability to pass title there is no utility in the borrowing. This may not be true in the cash driven market, but it is still important to pass title to the securities. Without title the borrower cannot, as OPS did here, dispose of the shares for commercial purposes. Moreover, the provision for netting following default would not operate effectively unless title to the securities lent and to the collateral given has passed to the opposite party.

Application of Principles

46 It is convenient to consider first whether the SLA is a mortgage. One of the essential features of a mortgage is that the mortgagor is entitled to get back the subject matter of the mortgage on returning to the mortgagee the money that he has received. The right is either contractual or exists in equity, and is referred to (sometimes loosely) as an equity of redemption. At law, if a mortgagor defaulted in payment of the secured debt the right of the mortgagee to the mortgaged property became absolute. In equity, however, the mortgagee could still redeem the mortgaged property, or recover the surplus if the mortgagee had sold the mortgaged property. The rule applied as much to real as to personal property: *Sewell v Burdick* (1884) 10 AC 74, 95; *Johnson v Diprose* [1893] 1 QB 512.

47 The problem that confronts Beconwood in its argument for a mortgage is that there can be no right to redeem in the case of an outright transfer of property, such as occurs in an absolute sale. In *Re George Inglefield Ltd* [1933] 1 Ch D 1, 27-28 Romer LJ analysed the difference between a transfer by way of sale on the one hand and a mortgage or charge on the other. He said (at 27):

> It appears to me that the matter admits of a very short answer, if one bears in mind the essential differences that exist between a transaction of sale and a transaction of mortgage or charge. In a transaction of sale the vendor is not entitled to get back the subject-matter of the sale by returning to the purchaser the money that has passed between them. In the case of a mortgage or charge, the mortgagor is entitled, until he has been foreclosed, to get back the subject-matter of the mortgage or charge by returning to the mortgagee the money that has passed between them.

48 There is also the following passage in Coote (at 28-29):

> It is not always easy to discriminate between a mortgage and a sale qualified by a power to repurchase. In determining questions of this nature, it must be borne in mind that a mortgage cannot be a mortgage on one side only; it must be mutual; that is, if it be a mortgage with one party, it must be a mortgage with both. But the rule only requires that it shall not be competent to one party alone to consider it a mortgage. In other respects the rights of the parties may be different, for it happens not unfrequently, that one party may not be able to foreclose at a time when the other party may redeem. … The rule is that prime facie an absolute conveyance, containing nothing to show the relation of debtor and creditor, does not cease to be an absolute conveyance and become a mortgage merely because the vendor stipulates that he shall have a right to repurchase. In every case the question is what, upon a fair construction, is the meaning of the instruments, and the absolute conveyance will be turned into a mortgage if the real intention was that the estate should be held as a security for the money. … The deed may be absolute in form but still a mortgage, and the absence of a proviso for redemption will not prevent its being a mortgage.

49 Most of this passage was taken from *Alderson v White* (1858) 2 De G & J 97, 105 [44 ER 924, 927-928], a case that was cited with approval by Windeyer J in *Gurfinkel v Bentley Pty Ltd* (1966) 116 CLR 98, 113. The question that arose in the latter case was whether a transaction by which the defendant became the proprietor of land previously owned by the plaintiff was entered into for the purpose of securing the payment of a debt lent by the defendant to the plaintiff – that is, whether the land was held as security with the plaintiff having an equity of redemption. The alternative was that the plaintiff had sold the land to the defendant upon terms that he should have an option to purchase it upon certain conditions: *Gurfinkel* 116 CLR at 115-116. The court found that the transaction was, in fact and in law, what it purported to be according to the terms of the agreement between the parties. After referring to *Alderson v White*, Windeyer J went on to point out (at 114) that the court is reluctant to hold that "a bargain is not as the parties expressed it. A court will … ordinarily

take at their word persons who execute a [particular agreement unless] it can be shewn by parol evidence that both parties to a document adopted the form they did as a disguise."

50 In light of the foregoing, the argument that the SLA can be characterised as a mortgage is simply unsustainable. It breaks down at many points. First of all, by the express terms of the SLA, unencumbered title in both lent securities and collateral passes on delivery. Secondly, when the transaction comes to an end there is no obligation to hand back in specie the securities initially lent. Nor is there an obligation to return the collateral actually provided. The obligation falling on the borrower is to deliver the same number and type of securities. The same is true as regards the collateral. Third, there are the netting and set off provisions that come into effect on default. This is the means by which the parties mitigate credit risk, converting redelivery obligations into payment obligations. The provisions are particularly important because they confirm that the parties did not intend there to be any equitable property rights retained over lent securities or collateral following their delivery, for if such rights existed, they could not simply be converted by contract to monetary obligations. Equity does not allow the redemption to be "clogged": *Kreglinger v New Patagonia Meat and Cold Storage Co Ltd* [1914] AC 25, 61; E I Sykes and S Walker, *The Law of Securities* (5th ed, 1993) at 70.

51 I also want to put to rest Beconwood's argument that the SLA should be characterised differently from any other share lending agreements because the SLA was made in a different market (ie the retail market as opposed to the institutional market) and between different participants. First of all, I disagree with one fundamental premise of this argument, namely that the transactions which are given effect by the SLA and other securities lending agreements take place in different markets. The view I take is that as each agreement may be used for financing purposes they are made in the same market, namely the market for providing funding to intending share purchasers. In any event, even if they be different markets, that would not, in my view, be good reason for giving a different meaning to the same agreement. This is because I do not accept that a share lending agreement (indeed any agreement) can have a meaning that is dependent upon (and changes with) the subjective motivations for which it is entered into.

52 What Beconwood's argument comes down to is this. Being an unsophisticated investor, it did not know what it was getting into when it signed the SLA and its lack of sophistication is a sufficient reason to give the SLA a construction it would not bear if entered into by skilled market players such as investments banks, hedge funds or arbitrageurs. I do not accept this argument either. Beconwood borrows for, and invests millions of dollars in, share trading. It does not qualify as an unsophisticated investor. It certainly is not a candidate for the special protection courts give to the weak and vulnerable.

53 Beconwood's attempt to characterise the SLA as a mortgage might be attractive if one were permitted to have regard to the economic substance of the arrangement. In the cash driven market, securities lending is a means of obtaining finance and for that reason has features similar to a mortgage. In each case a person (the lender of securities and the mortgagor) receives cash. In each case the person who receives the cash pays a fee for its use. In one case (securities lending) the lent securities are a proxy for collateral. In the other (a mortgage) they constitute the security. Further, in many share funding arrangements it is common to find provisions for topping up the value of the shares lent or put up as security (as the case requires) if there is a fall in their price. Despite these similarities, however, the arrangements are not of the same legal character. They are different means of achieving a similar result. Put another way, while the economic substance of the transactions (mortgage and securities lending) may be similar, the legal mechanism by which they are effected is fundamentally different.

54 Beconwood seeks to overcome these difficulties (and in so doing should concede the weakness of its mortgage case) by arguing that there is a charge in its favour over the Equivalent Securities. The way the argument proceeds is as follows. Upon delivery to it of the lent shares, title passes to OPS. At that point the shares, because they are identical in number and type to the lent shares (Securities), immediately fall within the definition (and thus assume the character) of Equivalent Securities which, in due course, must be delivered to Beconwood. The crux of the argument is that under the SLA OPS has an implied obligation to hold or retain an interest in any shares that meet the definition of Equivalent Securities as soon as it receives or obtains such securities. In those circumstances, Beconwood contends that it has a charge, or some kind of equitable interest, over the shares until it obtains legal title on the transfer back.

55 There are several problems with this argument. The first and most obvious is that the putative implied obligation upon which the whole argument is founded does not satisfy the requirements for an implied term. The principles on which a term may be implied are well established. For a term to be implied in fact, the term must be "so obvious that it goes without saying": *Codelfa* 149 CLR at 346-347, 354-356, 404-405 citing *Shirlaw v Southern Foundries (1926) Ltd* [1939] 2 KB 206, 227. Moreover, the supposed implied term must be reasonable and equitable: *BP Refinery (Westernport) Pty Ltd v Shire of Hastings* (1977) 180 CLR 226, 283. Looking at the SLA, I can see no necessity for the implication of the term. Nor are the criteria set out in *BP Refinery* satisfied. The term is sought not so much to make the SLA work, but to help convert it into a mortgage or charge. That is not a proper foundation for the implication of a term.

56 The second problem is equally fundamental. Having regard to the definition of "Equivalent Securities", the fact that OPS immediately holds, or may at some future point come to hold, shares that are the same as those it has borrowed does not convert those shares into "Equivalent Securities". It is true that, according to the definition, "Equivalent Securities" are securities "of an identical type, nominal value, description and amount" to the lent securities. But it is equally true that the definition does not require the lent securities (or even any particular batch of securities identical in number and type to the lent securities that happen to be received by OPS prior to its obligation to deliver Equivalent Securities falling due) to be Equivalent Securities. Rather, the SLA contemplates that OPS will deal with the lent securities as it sees fit and that, in order to meet its obligation to return "Equivalent Securities" in accordance with cl 6.1, it may have to get them in. This it can do from its own holdings or in the open market.

57 Put another way, OPS has the freedom to decide how and from whom it will obtain securities that answer the description of "Equivalent Securities". Crucially, there is no provision in the SLA restricting OPS from disposing of the lent shares or requiring OPS to keep on hand at any time specific securities for delivery to Beconwood as Equivalent Securities. In these circumstances, Beconwood cannot obtain a legal or equitable interest in any shares, even if they meet the description of Equivalent Securities, before shares that satisfy the description are appropriated to the agreement: *Re Goldcorp Exchange Ltd* [1995] 1 AC 74. This is no more than an application of the rule that until property which is

previously unidentified is appropriated to an agreement, neither a legal nor an equitable interest in that property can be created by that agreement: *Hoare v Dresser* (1859) 7 HLC 290 [11 ER 116]; *Citizens' Bank of Louisiana v First National Bank of New Orleans* (1873) LR 6 HL 352.

58 It merits mention, however, that under the SLA even appropriation may not be sufficient. This is because cl 3.1 provides that title in Equivalent Securities will pass on redelivery. Until that point OPS may be free to deal with its shares in whatever way it sees fit.

Automatic Netting

59 Although it does not affect the determination of the question presented, I should briefly address the argument that the netting provision in cl 7.4 has come into effect automatically because an Event of Default has occurred. The issue here is whether either the appointment by a debenture holder of a receiver to take control of OPS' assets or the appointment of an administrator under Pt 5.3A of the *Corporations Act 2001* (Cth) to take control of the company's affairs amounts to the appointment of an officer "analogous" to a liquidator: see cl 11.1(d). Beconwood conceded that whatever interest it had in the shares would be lost if the appointment of receivers or administrators falls within the clause.

60 In my view the role and function of, on the one hand, a party-appointed receiver or an administrator and, on the other hand, a liquidator, are not analogous. The role of a liquidator is to get in the assets of the company that is being wound up, dispose of those assets and out of the proceeds discharge the debts due to creditors (pro rata if there is a deficiency) and pay the balance (if there be a balance) to the contributories. When this task is complete the company is finished. This is in marked contrast to the role of a party-appointed receiver or an administrator. A party-appointed receiver takes control of the company's assets (and sometimes manages its business), but for the single purpose of discharging the debt due to his appointer, the secured creditor. The receiver holds any surplus he has secured for the benefit of the company. On his retirement the company continues in existence. An administrator does little more than take over the running of the company, and then only for a relatively short period. This enables the creditors to decide the company's fate.

61 In reaching the conclusion that a party-appointed receiver or an administrator is not "analogous" to a liquidator, I have derived no assistance from the definition of "Act of Insolvency" which provides (in cl 22(e)) that one such act is "the appointment of a receiver, administrator, liquidator or trustee or analogous officer of such Party over all or any material part of such Party's property." The question in cl 22(e) whether an officer is "analogous" to a class of receivers, administrators, etc is not the same as whether as in cl 11.1(d) an officer is "analogous" to a liquidator only. If one is to look for some common thread that binds the larger class, it may be found in the control each of them has over the assets or operations of the Party's property. But the wording of cl 11.1(d), where the class is narrower, requires a different construction.

62 In my view, therefore, there has been no automatic trigger of the netting provision, and Beconwood's concession does not bear on its claimed entitlement.

US Cases

63 The conclusion I have reached on the effect of the SLA is in line with the authorities in the United States. The US position on securities lending has been settled for more than 80 years. In holding that such agreements mean what they say (ie they are purchase-and-sale rather than secured loan agreements) and rejecting an equitable interest claim of the kind pursued here, the US Supreme Court in *Provost v United States* (1926) 269 US 443 succinctly stated the basic principle behind securities lending (at 456):

> For the incidents of ownership, the lender [of securities pursuant to a securities lending agreement] has substituted the personal obligation, wholly contractual, of the borrower to restore him, on demand, to the economic position in which he would have been, as owner of the stock, had the loan transaction not been entered into.

64 The Supreme Court also made clear what necessarily follows from that holding; namely, in "redelivering" stock to the lender, there is no obligation on the borrower to give back the original stock, or even any particular stock (at 456):

> When the borrower returns the borrowed stock, he acquires it by purchase or by borrowing again and in the process acquires and transfers to the lender all the incidents of legal ownership in securities which neither possessed before.

65 Lower courts have reaffirmed and applied these principles in a variety of contexts: *Granite Partners LP v Bear, Stearns & Co Inc* (SDNY 1998) 17 FSupp2d 275; *Re County of Orange* (CD Cal 1998) 31 FSupp2d 768; *SEC v Drysdale Security Corp* (2d Cir 1986) 785 F2d 38; *In re Bevill, Bresler & Schulman Asset Management Corp* (DNJ 1986) 67 BR 557, aff'd sub nom *Bevill, Bresler & Schulman Asset Management Corp v Spencer Savings & Loan Association* (3d Cir 1989) 878 F2d 742. If there is one constant theme across the cases, it is that agreements made using industry-standard documentation should be honoured according to the practices and expectations of the securities industry; to do otherwise would be to risk impairing the efficient functioning of national and international capital markets: *Granite Partners* 17 FSupp2d at 302-303; *Re County of Orange* 31 FSupp2d at 778; *Bevill* 67 BR at 597-598. To refuse to give effect to securities lending agreements in this context would be to revisit upon the market all of the difficulties involved with rehypothecation and the illiquidity of encumbered securities, in respect of which see R Elias, "Legal Aspects of Swaps and Collateral" (2001) 3(6) *Journal of International Financial Markets* 232, 239-240.

66 With respect to the legal rationale, as distinct from the foregoing policy rationale, given for reaching this result, the US courts have, in large measure, relied on the same principles of construction that I have applied. First and foremost is the rule that effect must be given to the plain language of the contract construed as a whole and the objective intentions of the parties as can be gathered therefrom: see eg *Modern Securities Transfers* (3rd ed, 2007) s 6a:17 nn 14-15 and surrounding text. For example, in *Provost* 269 US at 455, one of the reasons that the Supreme Court rejected the equitable interest theory was that the agreement contained no provision restricting the broker from disposing of the shares or requiring the broker to "at all times have on hand specific securities for delivery to the customer on payment of the amount of the broker's advances for the customer's account". Similarly, in *Bevill* 67 BR at 597, the court concluded that the "unequivocal language of purchase and sale … is strong prima facie evidence that the parties intended the transactions to be treated accordingly". See also *Granite Partners* 17 FSupp2d at 302 (stating that the unequivocal intention of the parties as evinced in the language of the agreement must be honoured).

67 It is true that US courts will (as Australian courts also will) look to extrinsic evidence in construing securities lending agreements if the plain language is ambiguous. For example

in *Bevill* 67 BR at 590 the court stated that consideration of extrinsic evidence was appropriate because the agreements there also had "terms customarily found in secured loan transactions". However, the court went on to say (at 598) that "[t]he mere presence of secured loan characteristics in [securities lending] agreements is not enough to negate the parties' voluntary decision to structure the transactions as purchases and sales" (quoted with approval in *Granite Partners* 17 FSupp2d at 302).

68 Second, the US cases also adhere to the view that a commercial contract should be construed with a view to the background, context, and market in which the parties are operating: *Bevill* 67 BR at 597, quoted with approval in *Granite Partners* 17 FSupp2d at 301; see also *Modern Securities Transfers* s 6a:17 n 17 and surrounding text.

69 Third, the US authorities appear to adopt the same view of Lord Devlin in *Chow Yoong Hong* [1962] AC 209 that the economic substance of a transaction does not and should not affect the legal characterisation of the contract between the parties to the transaction. In *Bevill* 67 BR, the court expressed the point as follows (at 597, also quoted with approval in *Granite Partners* 17 FSupp2d at 301):

> [W]hile the risk of market fluctuations in the value of the underlying securities rests with the original seller, this truism is of no legal consequence. The seller's interest in the market value of the securities is no greater in a secured loan transaction where he retains beneficial ownership of the securities than in a purchase and sale transaction where he is contractually bound to reacquire ownership of them. Clearly, any attempt to determine whether a repo or reverse repo transaction is more like a secured loan than a purchase and sale by weighing economic factors on a finely tuned balance scale would be an essentially formalistic and ultimately unproductive exercise.

70 There is one area in which it may appear at first glance that the US authorities diverge. While it is accepted in the US that, as between the parties to the transactions, securities lending agreements are to be honoured as purchase-and-sales rather than loans, the courts have also stated that such agreements may be characterised differently in other contexts: see *Nebraska Department of Revenue v Loewenstein* (1994) 513 US 123 (treating a repo as a collateralised loan under a certain provision of the tax code); *Resolution Trust Corp v Aetna Casualty & Surety Corp of Illinois* (7^{th} Cir 1994) 25 F3d 570 (treating a repo as a collateralised loan for purposes of a loan-loss exclusion in an insurance agreement). Without

descending too far into the details of these cases, the important point for present purposes is to clarify that they do not represent a contrary line of authority; rather, they simply stand for the proposition that although the court should, on general freedom of contract grounds, honour the structure of a transaction adopted by the parties *as between those parties*, that says nothing about how those agreements should be viewed with respect to the operation of legislative acts or third party obligations external to the securities lending contract and unrelated to the question of ownership.

71 The Supreme Court in *Loewenstein* put the point this way (513 US at 133-34):

> We do not believe it matters for purposes of § 3124(a) [the provision of the tax legislation at issue] whether the repo is characterized as a sale and subsequent repurchase [or as a loan]. A sale-repurchase characterization presumably would make the [securities borrowers] the "owners" of the federal securities during the term of the repo. But the dispositive question is whether the [securities borrowers] earned interest on "obligations of the United States Government," not whether the [securities borrowers] "owned" such obligations. As [the securities lender] himself concedes, "[t]he concept of 'ownership' is simply not an issue under 31 U.S.C. § 3124."

72 In other words, *Loewenstein* simply stands for the unobjectionable proposition that the operation of a legislative act with respect to a given commercial transaction is not necessarily determined by the structure given to that transaction in the contract of the parties. Moreover, the Supreme Court (at 134) cautioned that characterisation in one context does determine characterisation of securities lending agreements in all other contexts:

> [The securities lender] does not specifically dispute [that in economic reality, the securities borrower receives interest on cash it has lent to the securities lender] but argues that repos are characterized as ordinary sales and repurchases for purposes of federal securities, bankruptcy, and banking law as well as commercial and local government law. We need not examine the accuracy of these assertions, for we are not called upon in this case to interpret any of those bodies of law. Our decision today is an interpretation only of 31 U.S.C. § 3124(a)—not the Securities Exchange Act of 1934, the Bankruptcy Code, or any other body of law.

73 The decision in *Resolution Trust Corp* 25 F3d 570 rests on similar reasoning. There the question was whether a loss incurred by a party to a repo transaction gone bad was excluded from coverage under a policy insuring against theft or loss of securities because of an exclusion for "loss resulting directly or indirectly from complete or partial non-payment

of, or default upon, any loan or transaction in the nature of a loan or extension of credit": at 576. In response to the insured's argument that the purchase-sale form of the transaction expressed in the contract between the parties to the securities lending agreement should govern the operation of the insurance agreement as well, the court stated (at 578):

> This [argument] misses the mark, however, for the issue here is not whether the parties to the repurchase transactions … intended them to be loans or purchases, but rather is whether the parties to the insuring agreements … intended that losses stemming from repurchase transactions be covered under [the insurance agreement]. The language of the Loan-Loss Exclusion, which broadly excludes from coverage losses resulting from default upon any transaction "in the nature of a loan," clearly indicates that whether a particular transaction falls within the exclusion is determined by its economic substance, not by the labels attached to it by the insured and third parties dehors the insuring agreement.

74 That is to say, although the parties to a securities lending transaction may properly structure it as a purchase-and-sale as between themselves, there is nothing to prevent one of those parties from then entering into a separate contract with a third party to the effect that, for purposes of *that* agreement, the transaction is to be characterised other than as provided for in the first agreement.

Conclusion

75 I will answer the question raised for determination under O 29 (with some minor amendments) as follows:

Question: "Does a Lender of Securities 'loaned' to a Borrower under the Securities Lending and Borrowing Agreement (SLA) have an equity of redemption or other equitable estate or equitable interest in those Securities or in Equivalent Securities immediately upon or after the 'loan' of those Securities by the Lender to the Borrower?" (For purposes of this question, the expressions "Borrower", "Equivalent Securities", "Lender" and "Securities" have the meaning given to them in cl 22 of the SLA.)

Answer: "No".

I certify that the preceding seventy-five (75) numbered paragraphs are a true copy of the Reasons for Judgment herein of the Honourable Justice Finkelstein.

Associate:

Dated: 2 May 2008

Counsel for the Plaintiffs:	Mr M Garner
Solicitor for the Plaintiffs:	Holding Redlich
Counsel for the First and Fifth Defendants:	Mr A Archibald QC Mr P Crutchfield Mr C Moller
Solicitor for the First and Fifth Defendants:	Minter Ellison
Counsel for the Administrators:	Mr R Strong
Solicitors for the Administrators:	Mallesons Stephen Jaques
Date of Hearing:	21 April 2008
Date of Judgment:	2 May 2008

Securities Lending Review

22 August 2008

Securities Lending Review

This review of Australia and New Zealand Banking Group Limited's involvement in Securities Lending was conducted by Chief Executive Officer, Michael Smith assisted by David Crawford together with David Hisco, Managing Director Esanda; Chris Page, Head of Risk ANZ Asia Pacific and Bob Santamaria, Group General Counsel ANZ.

The report examines the development and management of Securities Lending within ANZ and its relationship with Brokers including the Opes Prime group.

The aim of the review is to address the legitimate expectations of ANZ's shareholders, its customers and the wider community, that the way in which ANZ conducts its business should meet the highest standards of ethics and business practice.

The report delivers on a commitment to provide an open and transparent account of the Bank's involvement in Securities Lending, to examine accountabilities within ANZ and to identify and undertake all necessary remedial actions.

ANZ recognises however that there remain broader legal issues to be resolved, particularly those associated with the losses incurred by the clients of the Opes Prime group. There are also significant impacts stemming from the failures of the Opes Prime group and Primebroker Securities on the lives of their clients and their families.

ANZ continues to believe its Equity Finance relationships with Brokers were undertaken on a strong legal foundation and in good faith, and this report does not seek to address these relationship issues directly.

ANZ does however recognise that the legacy of its involvement in Equity Finance may well be with the Bank for many years through legal cases that it will continue to defend and also the impact of these issues on its reputation.

This report has been presented to the ANZ Board, which has accepted the findings and fully supports the remediation program described within it. This report has also been provided to the Australian Prudential Regulation Authority (APRA) and the Australian Securities and Investments Commission (ASIC).

22 August 2008

Glossary of terms

AMSLA – Australian Master Securities Lending Agreement. This is a standardised agreement that is commonly used in Australia to document Securities Lending and Equity Finance arrangements.

ANZ – Australia and New Zealand Banking Group Limited.

Broker – in this Report, this term refers to a company to whom ANZ provided an Equity Finance facility, and which offered Equity Finance facilities to its clients. These companies include Opes and Primebroker.

CTC – Credit and Trading Risk Committee. This is an ANZ committee consisting of selected senior executives and is responsible for oversight and control of credit and market risk.

Equity Finance – a form of Securities Lending. The principal distinctions between Equity Finance and Standard Securities Lending are that the lender of securities is generally motivated by the desire to obtain cash financing by lending out securities that it holds and that, in practice, the collateral provided by the borrower to the lender under this form of transaction is generally less than the value of the securities borrowed.

LVR or loan-to-value ratio – in relation to an Equity Finance transaction, refers to the ratio of the collateral provided by the borrower of securities to the value of securities provided by the lender of those securities.

Primebroker – Primebroker Securities Ltd (Administrators appointed) (Receivers and Managers appointed).

Opes – refers to Opes Prime Stockbroking Limited (Administrators appointed) (Receivers and Managers appointed) or Leveraged Capital Pty Ltd (Administrators appointed) (Receivers and Managers appointed).

Securities Lending – a financial product that involves the temporary transfer of securities from one party (the lender) to another (the borrower) in return for cash or other securities (referred to as collateral). Under a Securities Lending facility the borrower is generally obliged to return borrowed securities (or equivalent securities) either on demand or at the end of any agreed term. The two principal forms of Securities Lending at ANZ were Standard Securities Lending and Equity Finance.

SLORC – Securities Lending Oversight Risk Committee. This was an ANZ committee that was established by the line and risk management officers responsible for the ANZ Securities Lending unit to oversee risk controls relating to Equity Finance and Standard Securities Lending.

Standard Securities Lending – a form of Securities Lending in which the borrower of securities is generally motivated by the desire to acquire particular securities on a short term basis (e.g. to settle 'short' sales). In practice, the collateral provided by the borrower to the lender under this form of transaction is more than the value of the securities borrowed.

Contents

1 Executive Summary

Introduction

This Review examined ANZ's involvement in Securities Lending, and in particular the development and management of ANZ's Equity Finance activities.

The Review was commissioned by the Chief Executive Officer of ANZ, Michael Smith, on 14 April 2008 following the collapse of the Opes Prime group, and was supported by the Board of ANZ.

ANZ's Securities Lending unit has operated since 1999 and the Equity Finance activities had evolved within that unit by 2001.

It is clear now that the differences between Equity Finance and other types of Securities Lending were not fully understood and appreciated by most ANZ staff involved in those products.

The Review Committee considers that, in hindsight, ANZ's Equity Finance business should not have operated in an environment where all the risks were not fully understood and managed. The business posed unacceptable reputational and financial risks to ANZ and these were not properly identified. These risks were compounded by the lack of a proper control environment with respect to the Equity Finance business.

Background

Securities Lending involves the transfer of legal and beneficial title to securities from one person to another in return for cash or other securities. The contractual terms between the parties enable the securities to be dealt with without restriction.

The recipient of the securities has an obligation to transfer an equivalent number of securities in exchange for repayment of the cash or securities originally provided.

Equity Finance is a form of Securities Lending where the value of the transferred securities is more than the value of the cash received in exchange. In this report, 'Equity Finance' is distinguished from 'Standard Securities Lending'.

From 2001, ANZ entered into Equity Finance and Standard Securities Lending arrangements with a number of 'Brokers', including Opes Prime Stockbroking Limited and Leveraged Capital Pty Ltd (referred to collectively as Opes) and Primebroker Securities Limited (Primebroker).

In this report, the term 'Broker' refers to a company to whom ANZ provided an Equity Finance facility, where that company offered Equity Finance facilities to its clients.

The securities lent to ANZ by Brokers were generally obtained as a result of the Equity Finance arrangements between the Brokers and their clients. That is, clients of a Broker would transfer securities to that Broker in exchange for cash collateral (or a right to draw down cash collateral when required). As the Brokers could deal with these securities without restriction, they could transfer them to other parties in return for other securities, or transfer the securities to banks, such as ANZ, in exchange for cash collateral.

The fact that Brokers sourced the securities from their clients was a key distinction between the Brokers and other parties with whom ANZ entered into similar arrangements. The particular consequences to ANZ of this distinction were demonstrated following the appointment of administrators to Opes and Primebroker in March and July 2008 respectively. These consequences were both financial and reputational.

The financial consequences include a provision, now sitting at approximately $70 million, that ANZ has made in relation to its exposure to Primebroker. Additionally there have been significant and ongoing costs in dealing with litigation and regulator requirements arising out of the Broker insolvencies. Provisions related to Securities Lending exposures were disclosed as part of ANZ's Trading Update on 28 July 2008.

The reputational consequences for ANZ arose primarily as a result of the position in which the Brokers' clients found themselves. Upon the appointment of administrators to Opes and Primebroker, clients lost the ability to recall securities that they had transferred to the Brokers, and instead became (or will become) unsecured creditors for any 'netted' amounts owed to them under the Equity Finance arrangements they had with the Brokers.

While clients of Brokers are understood to have signed agreements providing for the transfer of ownership of securities, when the Broker becomes insolvent, ANZ is seen to be, and in fact is, holding the securities that the Broker's clients may have expected would be returned to them. In realising these securities to protect its position, ANZ is regarded by some (including clients of the Brokers) as acting in its own interests and at the expense of the clients of the Broker.

Other issues that have compounded the damage caused to ANZ by its involvement in Equity Finance include:

- the amount of ANZ's financial exposure in respect of the Equity Finance business and the illiquidity of the securities acquired by ANZ to effectively hedge that exposure;
- the fact that five ANZ staff held, or had access to, trading accounts with Opes and some staff traded on those accounts immediately prior to the appointment of receivers.

Key findings and opinions

The Review Committee considers that there were a number of failures and deficiencies in relation to ANZ's Equity Finance business, as summarised below.

Lack of understanding of the distinction between Equity Finance and Standard Securities Lending – Line and risk management did not appear to fully understand the nature of Equity Finance and the differences between Equity Finance and Standard Securities Lending, including the different risks associated with Equity Finance (such as the reputational risk to ANZ arising from the financial standing and nature of the businesses of the Brokers that accounted for the majority of the Equity Finance business). This finding was a contributing factor to most of the other key findings.

Growth in initial business not widely known – There was limited understanding of the existence or significant scale of the Equity Finance business outside ANZ Custodian Services (within which the business resided) before March 2005.

Lack of a proper control environment – The Equity Finance business lacked an appropriate control framework, in particular with respect to credit limits and conditions relating to the quality and quantity of securities accepted by the Equity Finance business and the loan-to-value ratios applied to those securities. The lack of an appropriate framework was not identified by management until early 2005. The deficiencies identified were not then addressed effectively or in a timely manner. There was poor implementation of, and compliance with, the controls that were established.

Poor accountability and 'management by committee' – There was a lack of individual accountability within the line and risk management responsible for the Equity Finance business, with responsibility for many decisions resting with committees. This was compounded by deficiencies in the structure and management of the relevant committees.

Failure to identify and act on warning signs – Various concerns relating to the processes, personnel and systems utilised in the Equity Finance and Securities Lending businesses and the risks associated with these businesses were identified by various staff and in the course of internal audit reviews. However, they were not addressed in a timely or effective manner. There was a history of procrastinating on decisions to either invest in systems to remedy issues or to exit the business.

Failure to report relevant issues to the Chief Executive Officer and Board – The gravity of the issues relating to the Equity Finance business should have been, but were not, properly brought to the attention of the Chief Executive Officer and Board.

Breaches of ANZ employee conduct policies – There were breaches by some members of the ANZ Securities Lending unit of ANZ employee conduct policies.

Remediation actions

The Review Committee has identified 13 remediation actions to be undertaken by ANZ to address the findings contained in this report.

1. *Exit Equity Finance* – The Chief Executive Officer has directed that ANZ withdraw from the Equity Finance business in an orderly manner and rationalise Standard Securities Lending to a few key multinational institutional relationships.
2. *Disciplinary Actions* – There will be disciplinary actions involving a number of employees ranging from written warnings through to termination of employment.
3. *Code of Conduct and Ethics Policies* – ANZ will refresh all of its employee code of conduct, ethics and conflict of interest policies. This will be supported by additional awareness and training programs.
4. *Reputation Risk Framework* – ANZ will implement a new reputation risk framework to establish formal policy and accountability across ANZ for management of reputation risk.
5. *Performance Management Framework* – ANZ will create a new Performance Management framework to better reinforce accountability and compliance.
6. *Training for ANZ Senior Executives* – There will be training including problem escalation, the new Code of Conduct and ANZ's values and people management policies.
7. *Change the fundamentals of committees* – The structure and reporting lines of management committees (including the Credit and Trading Risk Committee or CTC) will be reviewed. This will ensure all committees have clear authority, guidelines, mandates to perform specific functions and accountabilities for performance and failures to perform. This review will also include the form of submissions and the process for recording follow up actions and decisions.
8. *Internal Audits and significant operational control issues* – ANZ will introduce more rigorous management of businesses with adverse Internal Audit ratings and operational control issues identified as 'high'.
9. *Product Management* – There will be a full review of the product approval process in ANZ.
10. *Review classification of facilities* – ANZ will develop an annually reviewed central register of the credit limit classification of all Institutional division products.
11. *Customer exposure reporting* – ANZ will improve exposure reporting to its senior risk and line management that monitors both size and movements in customer activity.
12. *Exposures without limits* – Business unit Managing Directors will undertake reviews to confirm there are no other areas with processes and systems which might permit potential drawdowns without proper arrangements in place.
13. *Wholesale Credit Risk Policy* – There will be a full review of the development and dissemination of the ANZ Wholesale Credit Risk Policy.

2 Introduction and overview of Securities Lending

Securities Lending involves the temporary transfer of securities from one party (the lender) to another (the borrower) in return for cash or other securities (referred to as collateral).

Under a Securities Lending transaction, the borrower can deal with borrowed securities without restriction. This is because full legal and beneficial ownership of the relevant securities are transferred from the lender to the borrower. However, the borrower is obliged to transfer an equivalent number of the same securities to those borrowed either upon demand by the lender or at the end of an agreed term, subject to repayment of the cash or other collateral originally provided by the borrower to the lender.

Securities Lending at ANZ took two principal forms, in this report referred to as 'Standard Securities Lending' and 'Equity Finance'.

The borrower in a Standard Securities Lending transaction is generally motivated by the desire to acquire particular securities on a short term basis (e.g. to settle 'short' sales). The lender is generally a financial institution such as a bank that holds large volumes of securities and wishes to generate fees, income or otherwise have access to liquidity by lending out those securities. In practice, the collateral provided by the borrower to the lender under this form of transaction is more than the value of the securities borrowed.

Under an Equity Finance transaction, the lender of securities is generally motivated by the desire to obtain cash financing by lending out securities that it holds. The borrower is generally motivated by the desire to earn interest on the cash it provides as collateral for the securities and to generate fees from on-lending the securities borrowed. In practice, the collateral provided by the borrower to the lender under this form of transaction will be less than the value of the securities borrowed.

In an Equity Finance transaction, the amount of collateral provided by the borrower is determined by reference to a loan-to-value ratio (LVR), which generally reflects the borrower's assessment of the quality of the securities being lent. For example, a borrower might apply an LVR of 30 per cent to a low quality security. The borrower would then pay cash equal to 30 per cent of the market value of the security as collateral.

The Securities Lending market uses standard documentation. The Australian standard is called the Australian Master Securities Lending Agreement (AMSLA). The AMSLA is based on agreements produced by the UK based International Securities Lending Association. There are standard securities lending agreements and industry associations in major financial markets throughout the world. The Australian industry association is the Australian Securities Lending Association (ASLA) (www.asla.com.au).

Under an AMSLA, where an event of default occurs, the parties' obligations to return borrowed securities and collateral ceases. Instead, the AMSLA provides for a monetary value to be attributed to each party's former obligation to return borrowed securities or collateral, and for those obligations to be netted off against each other.

3 The Review

3.1 Background

On 14 April 2008, ANZ Chief Executive Officer Michael Smith announced a review into ANZ's involvement in Securities Lending, and in particular the development and management of ANZ's Equity Finance activities including ANZ's involvement with Opes.

Mr Smith appointed a Review Committee consisting of himself and:

David Crawford, one of Australia's most experienced company directors with an extensive background in financial services and insolvency administration. Mr Crawford was appointed to ensure the rigour of the Review.

David Hisco, Managing Director Esanda. Mr Hisco joined ANZ in 1980 and has held a number of senior executive positions and has been a member of the Management Board of ANZ.

Christopher Page, Head of Risk Asia Pacific ANZ. Mr Page joined ANZ in January 2008 after a 34 year career with HSBC where he was most recently the Chief Credit Officer, Asia Pacific in which position he had responsibility for risk management activities across more than 20 countries.

Bob Santamaria, Group General Counsel ANZ. Mr Santamaria joined ANZ in August 2007 from Allens Arthur Robinson where he was the Executive Partner of the Corporate department.

The Review Committee was extensively supported in its work by a team of over 20 people, including senior ANZ staff and representatives of PPB Financial Advisors, PricewaterhouseCoopers and Allens Arthur Robinson.

3.2 Scope of the Review

The terms of reference of the Review were to examine:

- oversight and control of ANZ's involvement in Securities Lending and the development and management of ANZ's client relationships including with Opes;
- whether any employee had breached ANZ's internal policies, procedures and ethical standards in Securities Lending and in dealings associated with clients including Opes;
- compliance with Australian law and regulation in relation to Securities Lending;
- all necessary remedial actions to address the issues identified in the Review.

In conducting the Review, it became clear to the Review Committee that relevant issues of concern related primarily to the provision of Equity Finance by ANZ to Brokers (such as Opes and Primebroker). Therefore, the Review did not focus on ANZ's Standard Securities Lending operations (except to the extent that this product was offered to Brokers) or its involvement in the provision of Equity Finance to parties other than Brokers.

3.3 Process of the Review

The findings of the Review are based on facts and, where appropriate, opinions. Over the four months of the Review, the Review Committee had access to, and analysed:

- internal reports;
- customer files;
- internal and external correspondence;
- submission papers and minutes for various committees;
- reports generated by the ANZ Securities Lending unit;
- other records, including internal and external audit reports;
- interviews and discussions with directors, employees and former employees.

3.4 ANZ's relationship with Brokers

The Review Committee conducted extensive investigations into the relationship between ANZ and Opes and other Brokers. This included interviews with those ANZ employees who had business and personal dealings with Opes.

The Review Committee did not identify any evidence to suggest that any personal relationships between ANZ staff and specific Brokers contributed to the issues of concern relating to the Equity Finance business. This was the case notwithstanding that one of the principals of Opes, Lirim Emini, had previously been employed by ANZ and had worked with, and was a friend of, some members of ANZ's Securities Lending unit. Rather, the issues of concern appeared to be principally referable to the nature of the business, operational and governance matters.

Accordingly, relationships between ANZ and the Brokers are not addressed in detail in this report except where relevant to the holding of trading accounts with Opes by some of ANZ's employees.

3.5 Legal issues

The operation of ANZ's Securities Lending unit has given rise to a number of legal issues.

For example, there are a number of outstanding court proceedings and claims against ANZ. These include claims by Opes' administrators that a re-organisation of the Equity Finance and security arrangements between ANZ and Opes that occurred shortly prior to the appointment of administrators to Opes is voidable.

As part of its ongoing investigation of Opes, ASIC has required ANZ to produce various documents and it has conducted formal examinations of some ANZ employees. ASIC also requested that ANZ lodge substantial holding notices in respect of 'relevant interests' arising pursuant to certain AMSLAs. Whilst ANZ did not accept ASIC's view that notices were required, they were lodged (on the assumption that ASIC's view applied). In addition to complying with ASIC's request, ANZ also gave certain undertakings to the Takeovers Panel as a result of an application brought against ANZ.

All current legal issues are the subject of separate consideration by ANZ and its legal advisers. As these issues are or may become the subject of litigation, it is inappropriate at this time to provide any further information on them in this report.

4 ANZ's credit and risk governance structures

There are various levels of governance within ANZ.

4.1 Board and Board committees

4.1.1 Board

The Board is responsible to ANZ's shareholders for the governance of ANZ, and oversees its operations and financial performance.

The Board may delegate any of its powers and responsibilities to Committees of the Board. For the purposes of this report, the most relevant Board Committees are the Risk Committee and the Audit Committee.

4.1.2 Risk Committee

The Risk Committee approves risk management principles, policies, strategies, processes and control frameworks for the management of business, market, credit, operational, liquidity, and reputation risk. It may sub-delegate its powers to executives of ANZ. The Chief Risk Officer is the executive responsible for assisting the Chairman of the Risk Committee. The Risk Committee also approves facilities recommended by CTC which are above CTC's approval authorities.

4.1.3 Audit Committee

The Audit Committee is responsible, among other things, for overseeing and monitoring the work of ANZ's Internal Audit function. The Group General Manager Internal Audit reports directly to the Chairman of the Audit Committee.

4.2 Line and risk management

The Board delegates to the Chief Executive Officer, who delegates further to other senior management, the authority and responsibility for managing the everyday affairs of ANZ.

Various aspects of risk management are managed by different risk functions within ANZ (including market risk, credit risk and operating risk and compliance). ANZ operates its business through various divisions and subdivisions. Each division has a managing director or head of business unit. The reporting line through each level of management to the Chief Executive Officer is known as line management.

4.3 Management committees

There are various management level committees in ANZ. These include various risk, project specific and other committees. There are two such committees which are central to the focus of this report, being CTC and the Securities Lending Oversight Risk Committee (SLORC).

4.3.1 Credit and Trading Risk Committee

CTC is a senior executive committee which operates pursuant to discretions delegated to it by the Board and the Risk Committee. It comprises selected senior Risk Executives, senior Executives and Business Unit Managing Directors and is chaired by the Chief Risk Officer. The Chief Executive Officer is a member of the committee and may attend as necessary, but will not normally be expected to do so. In this regard the Chief Executive Officer did not attend the CTC meetings referred to in this report.

CTC's mandate is to approve credit and market risk control frameworks for ANZ's business. In November 2005, its mandate was extended to also cover reputational risk to ANZ. As part of its mandate, CTC is authorised to make general credit decisions and specific credit decisions for ANZ's larger or higher risk customers, and to approve credit, trading risk and non-traded market risk controls and each business unit's asset writing strategy.

CTC played a pivotal role in relation to the control framework established with respect to Equity Finance. It was asked to consider and approve key parts of the framework developed and recommended by senior line and risk management personnel.

4.3.2 Securities Lending Oversight Risk Committee

SLORC was established in April 2006 by line and risk management representatives responsible for the oversight of the ANZ Securities Lending unit for the purpose of providing oversight in the management of credit and market risk of the Securities Lending business (including the Equity Finance business).

5 Securities Lending and Equity Finance – commencement and development

Summary points

The Equity Finance business evolved out of ANZ's Standard Securities Lending business and was established without formal product approval. The differences between the Standard Securities Lending and Equity Finance businesses were not properly recognised, and the Equity Finance business was not widely known by management outside ANZ Custodian Services until March 2005.

The Equity Finance business grew rapidly with the encouragement of ANZ Custodian Services. By March 2005, when the first credit risk review of the business was undertaken, ANZ's financial exposure in respect of the business was $771 million.

There were deficiencies in the control framework for the Equity Finance business, including a failure to impose credit limits on customers. These deficiencies were identified in the above credit risk review but remedial actions were not implemented in a timely or effective manner.

5.1 History of Securities Lending at ANZ

ANZ has been involved in Securities Lending since the 1980s. In the 1990s, Securities Lending was conducted in different parts of ANZ including ANZ's retail stockbroking business (conducted by ANZ Securities Limited, then known as ANZ McCaughan Securities Limited) and ANZ Investment Bank (a division of ANZ).

In 1999, ANZ Securities Limited sold its retail stockbroking business. The Securities Lending activities were, at that time, discontinued by ANZ Securities Limited and adopted by ANZ Custodian Services. A dedicated team was created for this purpose (the ANZ Securities Lending unit).

5.2 Where does the ANZ Securities Lending unit fit within ANZ?

As shown in the following diagram, the ANZ Securities Lending unit is a part of ANZ Custodian Services which is a business within the Working Capital unit (formerly Trade and Transaction Services) in ANZ's Institutional division. The unit reports through to the Group Managing Director, Institutional and ultimately the Chief Executive Officer.

The diagram describes the current divisions and subdivisions. Over time, there have been several reorganizations and divisional name changes. However, the relative position of the ANZ Securities Lending unit within the hierarchy has remained fairly consistent over the years and the diagram provides an accurate reflection of its historical position within ANZ.

Assets held by the ANZ Custodian Services business are usually held by ANZ Nominees Limited (a wholly owned subsidiary of ANZ) as nominee or sub-custodian for ANZ. Securities transferred to ANZ in the course of Securities Lending or Equity Finance transactions were transferred to ANZ Nominees Limited as the nominee of ANZ.

5.3 Equity Finance in the ANZ Securities Lending unit

The ANZ Securities Lending unit was involved in Standard Securities Lending since inception.

It appears that the unit first became involved in Equity Finance on a small scale, but by late 2001, the product had grown to the point where it was considered to constitute a distinct offering and was referred to as 'Equity Finance'.

The terms 'equity finance' and 'equity financing' had been used in ANZ before 1999 although not necessarily for the form of Securities Lending now known as Equity Finance.

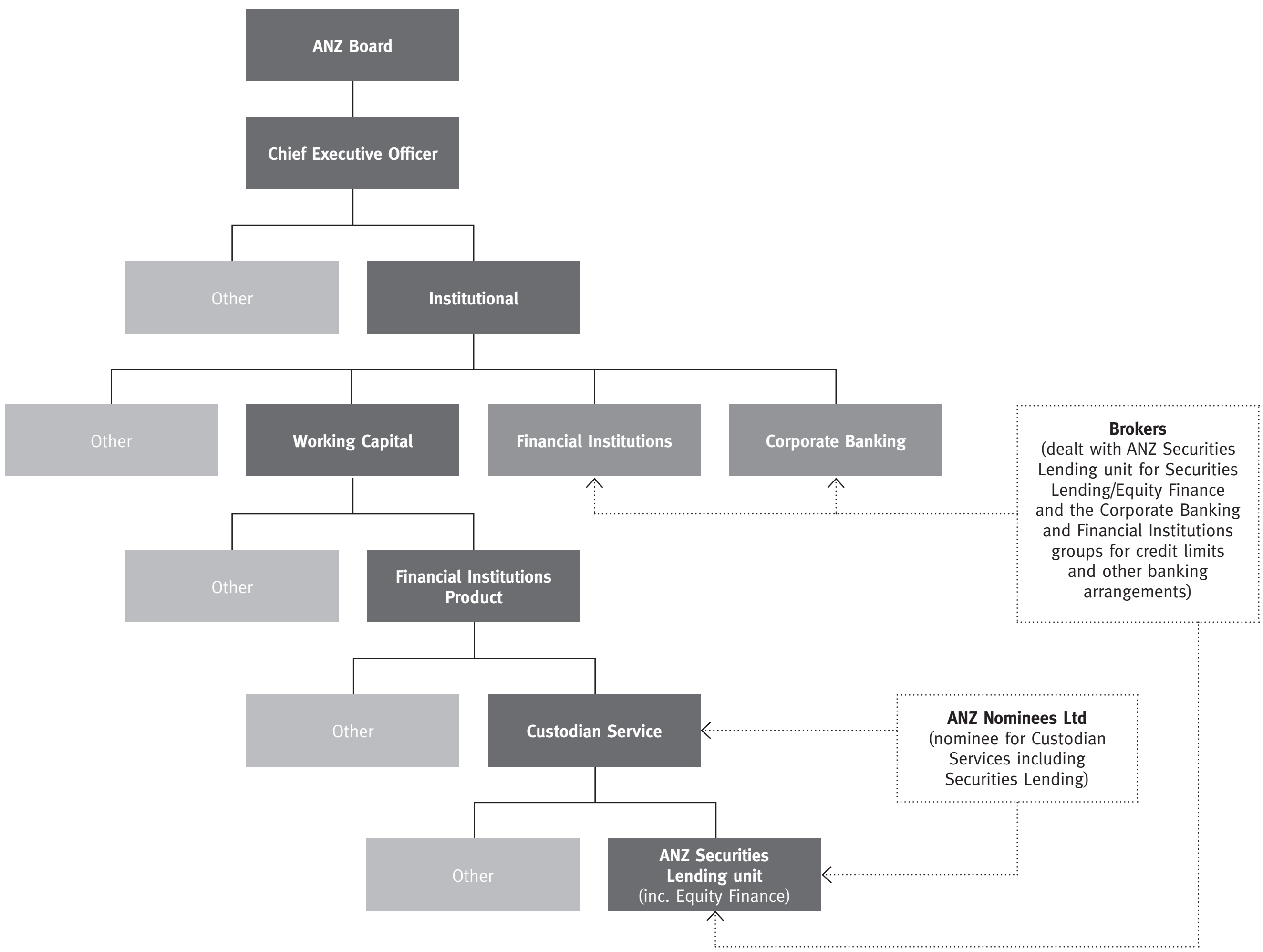
5.4 Approvals for Equity Finance

There is no record that any initial product approval was sought or obtained with respect to the Equity Finance product.

Within the ANZ Securities Lending unit, Equity Finance was often characterised as a part of Standard Securities Lending (or 'reverse stock lending') and not as a separate product.

ANZ's Wholesale Credit Risk unit (which sits within the Institutional Risk area) developed a Securities Lending Policy which was published in June 2002. The policy applied only to Standard Securities Lending and excluded Equity Finance. However, it did not exclude Equity Finance clearly, and was interpreted by ANZ Custodian Services and the ANZ Securities Lending unit as permitting Equity Finance.

Amendments to the Securities Lending Policy were published in May 2006 (with updates in October 2006 and March 2007). As part of the amendments, the policy was broadened to accommodate Equity Finance.



5.5 Encouragement for Equity Finance

At the same time as publication of the initial Securities Lending Policy, management within ANZ Custodian Services issued a set of brief 'guidelines' in relation to the Equity Finance business. The extent to which these guidelines were used in the day to day operations of the ANZ Securities Lending unit is unclear. The guidelines:

- did not limit ANZ's exposure to individual Brokers;
- did not restrict the types and concentrations of securities acceptable to ANZ;
- set a flat LVR without reference to the quality of securities accepted by ANZ.

In general, the ANZ Securities Lending unit was given freedom and encouragement by management of ANZ Custodian Services to grow the Equity Finance business.

From June 2002 (when the Securities Lending Policy was interpreted to permit Equity Finance) until March 2005 (when the first full review into Equity Finance by an ANZ risk officer was produced), ANZ's total financial exposure in relation to the Equity Finance business grew from $33 million to $771 million across a number of Brokers.

5.6 Risk review of Equity Finance in 2005

A credit risk assessment of the Equity Finance business was conducted in March 2005 by an ANZ risk officer, resulting in the production of a 'Securities Lending Review' report. Until this time, the existence of Equity Finance within ANZ was not widely known about or understood by management outside ANZ Custodian Services.

The Securities Lending Review report found that:

- while ANZ's Equity Finance product had similarities to ANZ's retail margin lending product, higher LVRs were applied and a much wider range of securities was accepted by ANZ;
- as at March 2005, ANZ had advanced $771 million to Brokers through the Equity Finance business;
- no credit limits had been established with respect to Brokers participating in the Equity Finance business and no process had been established to assess or manage counterparty credit risk.

The report was provided to relevant senior line and risk management. It recommended that no further expansion of ANZ's Equity Finance activities be undertaken and that credit limits be imposed with respect to the Brokers with whom ANZ had existing Equity Finance arrangements. Both of these recommendations were supported by a senior risk officer.

The recommendation to impose credit limits was also a requirement of CTC when the matter was raised in a submission in May 2005 seeking a credit limit for the largest Broker exposure.

Following the report, the Equity Finance business did not accept any new customers. However, exposures to existing customers were not capped at then current levels pending formal determination of credit limits for those customers.

There was a substantial delay in determining these credit limits. A limit was approved for only one Broker during 2005. Limits for the other Brokers were not approved until mid 2006. ANZ's financial exposure to these other Brokers more than doubled between the date of the Securities Lending Review report and the date on which credit limits were eventually imposed.

6 Risks associated with ANZ's Equity Finance operations

The level of risk associated with ANZ's Equity Finance business was firstly a function of the lack of credit limits and, when credit limits were applied, the classification of those limits. It was also a function of the LVR models applied, including the quality and concentrations of securities accepted by ANZ. A further risk emerged with respect to the financial standing of, and nature of the businesses operated by, Brokers to whom ANZ provided Equity Finance facilities.

6.1 Classification of credit limits

Summary points

For internal reporting purposes, the Brokers' Equity Finance exposures were recorded at 10 per cent of the face value of funds made available to them. This was on the basis that ownership of the collateral by ANZ reduced the risk of loss of those funds. Recording the exposures at 10 per cent of the face value meant that the exposures were not as visible as they would have been had they been recorded on a fully funded basis.

In normal circumstances, ANZ sets credit limits with respect to the various products that it agrees to provide each customer. In determining credit limits for a particular customer, ANZ will have regard to the nature of its exposure to that customer. That exposure will, in turn, vary depending upon the nature of the product offered to the customer.

In the case of standard lending facilities such as overdrafts, loans and financial guarantees ANZ agrees to provide actual (or contingent) funding to its customers and potentially has exposure to the full amount provided. As such, credit limits for these products are determined and recorded in internal reports on a 'fully funded' basis by reference to 100 per cent of the funds available.

Under other types of facilities such as swaps, derivatives and Standard Securities Lending, ANZ does not have exposure to the full face value of the relevant transaction. In the event of customer default, ANZ will normally manage its potential exposure under the transaction by entering into a compensating transaction with another counterparty. In accordance with accepted banking practices, ANZ records limits for such transactions at a percentage of the face value of the transactions reflecting their assessed 'potential exposure risk'.

In April 2006, and following the 2005 Securities Lending Review, a senior risk officer decided that credit limits for Equity Finance should, for internal reporting purposes, be classified on the basis of potential exposure risk, as was the case for Standard Securities Lending facilities. The exposure was calculated at 10 per cent of the face value of funds made available.

This had the effect of reducing the visibility of the Equity Finance business within ANZ (although the Review Committee considers that this was not the intended result of the decision to adopt the potential exposure risk approach). For example, if ANZ imposed a credit limit of $50 million in respect of a particular Broker, the ANZ Securities Lending unit could enter into transactions with that Broker to the value of $500 million of cash or securities. However, the limit of $50 million would be shown for the purposes of internal reporting of large exposures to senior management, Risk Committee and the Board.

The amount of cash and securities advanced by ANZ to Brokers peaked at approximately $2 billion in August 2007, although classification of credit limits on the basis of potential exposure risk meant that the recorded exposures would have been calculated at around $200 million.

6.2 LVR models

Summary points

In February 2006, a risk model was adopted that permitted the Equity Finance business to accept any listed security and which did not limit exposures to individual securities. This resulted in ANZ acquiring many large holdings of illiquid securities in companies with small market capitalisations.

Implementation of an improved risk model which addressed these issues was significantly delayed.

In late 2005, ANZ Market Risk began to design an LVR model for Equity Finance. The model that was developed permitted any listed security to be accepted regardless of its liquidity or the market capitalisation of the relevant company. In contrast, the securities that were approved at that time for the purposes of ANZ's Retail Margin Lending operations were restricted to a list of approximately 300 securities.

Further, the model did not impose limits on the percentage of issued shares of a particular company that could be accepted. This allowed the Equity Finance business to acquire high concentrations of securities in companies with a small market capitalization.

Finally, the model did not apply effectively where ANZ provided both Standard Securities Lending and Equity Finance products to a Broker on the one portfolio (ie where the Broker provided securities to ANZ and in return received a combination of cash under an Equity Finance facility and securities under a Standard Securities Lending facility). In these circumstances, the model calculated LVRs on each security and provided a value for the entire portfolio of securities provided by the Broker. The model did not match particular securities provided by the Broker against the cash provided to the Broker under the Equity Finance facility on the one hand or the securities provided to the Broker under the Standard Securities Lending facility on the other. This resulted in higher quality securities provided to the Brokers (under a Standard Securities Lending facility) effectively being supported by lower quality securities in the portfolio of securities provided by the Broker.

ANZ Market Risk developed a second LVR model from July 2006 which addressed the abovementioned faults. However, there were significant delays in implementing the second LVR model, with final implementation occurring in March 2008. This was too late to have an improving effect on the portfolio of securities provided by Opes and Primebroker.

6.3 Nature of Brokers' business

Summary points

ANZ's Equity Finance arrangement with a Broker gives rise to a potentially significant reputational risk in addition to financial risk. This arises because securities transferred by the Brokers to ANZ are primarily obtained as a result of Equity Finance transactions between the Brokers and their clients. Should the Broker become insolvent, ANZ in protecting its position by selling those securities, may be seen to have acted in its own interests and to the detriment of the Broker's clients.

While ANZ provided Equity Finance facilities to a small number of non-Broker companies, the majority of the Equity Finance business was conducted with Brokers.

The securities transferred by the Brokers to ANZ were primarily obtained by the Brokers as a result of Equity Finance transactions between the Brokers and their clients. That is, clients of a Broker would transfer securities to that Broker in exchange for cash collateral (or a right to draw down cash collateral when required). A Broker could then in turn, and in many cases did, transfer those securities to banks like ANZ in exchange for cash collateral.

Under an AMSLA, where an event of default occurs, the parties' obligations to return borrowed securities and collateral end. Instead, the AMSLA provides for a monetary value to be attributed to each party's former obligation to return borrowed securities or collateral, and for those obligations to be netted off against each other.

If a Broker becomes insolvent, there will be two netting off events: a netting off between ANZ and the Broker, and a netting off between the Broker and its clients.

If the netting off between the Broker and its clients results in payments being due to the clients from the Broker, the clients may not receive full payment as a result of the insolvency of the Broker.

As such, in entering into Equity Finance arrangements with Brokers, ANZ was incurring significant reputational risk. If a Broker becomes insolvent, ANZ is seen to be, and in fact is, holding the securities that the Broker's clients expected in normal circumstances would be returned to them. In realising these securities to protect its position, ANZ could be regarded by the clients of the Broker as acting in ANZ's interests and at the expense of the clients of the Broker.

Equity Finance arrangements expose ANZ to financial risk, reputational risk and the risk of potential litigation. These risks have been demonstrated in the case of Opes. While Opes' clients are understood to have signed agreements providing for the transfer of ownership of securities, many of those clients assert that they regarded their arrangements with Opes as a form of margin lending. Some claim that they did not understand that there was a full transfer of legal and beneficial title in securities to Opes, and that Opes was then free to deal with those securities without restriction, including by transferring them to ANZ.

7 Operation, governance and oversight of Equity Finance business – opinions

The Review Committee's conclusions regarding the operation, governance and oversight of the Equity Finance business are set out below.

7.1 There was a lack of understanding of the distinction between Equity Finance and Standard Securities Lending

The Review Committee considers that line and risk management did not appear to fully understand the nature of Equity Finance and the differences between Equity Finance and Standard Securities Lending. They did not undertake sufficient enquiries to understand fully the business and were often reliant on the views of the ANZ Securities Lending unit.

The lack of recognition of the distinction between Equity Finance and Standard Securities Lending initially resulted in the Equity Finance business being established without any product approval or oversight.

Subsequently, the lack of understanding led to errors and omissions in upward reporting of relevant issues. In some instances, incorrect information was provided.

In particular, CTC was not provided with all information required by it to properly consider the matters submitted to it in relation to the Equity Finance business.

The Review Committee does not consider that submissions to CTC regarding Equity Finance were deliberately inaccurate or misleading. Nonetheless, the errors and omissions in the submissions to CTC were unacceptable.

7.2 There were deficiencies in the Securities Lending Policy

ANZ's Securities Lending Policy was issued in June 2002. The policy was intended to apply only with respect to Standard Securities Lending and to exclude Equity Finance. Amendments to the Securities Lending Policy were published in May 2006 (with updates in October 2006 and March 2007). Amongst other things, those amendments expanded the Securities Lending Policy to cover Equity Finance.

The Review Committee considers that the amended Securities Lending Policy is not of an appropriate standard. It is not structured in a logical manner and does not apply relevant principles in a systematic way to the various Securities Lending products offered by ANZ.

The initial Securities Lending Policy was not updated for almost three years, during which period there had been significant growth in ANZ's Equity Finance business. This growth should have prompted a thorough review of the risks associated with the business and the adequacy of the policy. Instead, later policies simply built upon the earlier policies on a piecemeal basis.

7.3 There was lack of compliance with approvals and policies

In mid-2005, CTC approved various controls to be applied to the Equity Finance business.

A number of these controls took an unacceptably long time to be implemented, in particular controls requiring the funding to a Broker to be reduced or the types of securities to be accepted from a Broker to be limited. For example, where a new credit limit was less than the current exposure to the Broker, the ANZ Securities Lending unit did not stop accepting securities and continued to provide funding. These excesses were generally only brought under control when higher credit limits were approved for the Brokers.

Where a control imposed a new procedure (such as stress testing of the portfolios), implementation would often be delayed. Further, controls on the overall size of the business were often exceeded in the apparent belief by relevant line and risk management that retrospective approvals could be easily sought and obtained.

The Review Committee believes that, in general, ANZ Custodian Services sought to grow the Equity Finance business without sufficient reference to the controls approved for the business by ANZ's risk functions. This was exacerbated by the absence of processes to measure compliance with relevant controls and the fact that no disciplinary measures were imposed if a policy or approval was not followed.

7.4 Credit limits were calculated on a basis that reduced the visibility of the Equity Finance business

The credit limits (as described in section 6.1) that were eventually applied to Equity Finance facilities were calculated on the basis of a potential exposure risk of 10 per cent of funding made available by ANZ. One effect of calculating the limits on this basis was to reduce the visibility of the Equity Finance business within ANZ.

The basis on which the credit limits should be calculated can be a matter of judgement, and there are arguments which support the election of a potential exposure risk based limit in this case. However, the Review Committee considers that:

- given the complexity and potential significance of the issue, the decision to adopt the potential exposure risk model should have been brought to the attention of CTC, and by way of a hindsight review, to the Chief Risk Officer;
- the decision to adopt the potential exposure risk model should only have been made once confirmation had been received that credit limits were being observed and that the Equity Finance business was being restricted to a list of acceptable securities;
- there was insufficient rigour in relation to the decision to calculate the exposure at 10 per cent of ANZ's potential gross exposure.

7.5 There were deficiencies in the LVR models applied in the Equity Finance business

The Review Committee considers that the LVR model for Equity Finance developed in late 2005 had several key deficiencies. In particular, the model did not impose appropriate restrictions on the types of securities, or the percentage of issued shares of a particular company, that could be accepted by the Equity Finance business.

Although development of a second LVR model was commenced in July 2006 which addressed these issues, there were substantial delays in implementing the new model.

7.6 Limitations of CTC

Key decisions relating to Equity Finance were presented to and approved or ratified by CTC in the period from May 2005 to November 2006. CTC makes decisions based on information and recommendations submitted to it by key senior line and risk management personnel.

The Review Committee considers that CTC was not provided with all relevant information that would have allowed it to make informed decisions as to the appropriate controls that should have been implemented. Accordingly, the approvals provided by CTC were inadequate in that CTC was not expressly alerted to the fact that:

- the LVR model they were asked to approve did not adopt CTC's previous instructions regarding restrictions on acceptable securities and on concentration in individual securities;
- the credit limits for Equity Finance were to be calculated on a potential exposure risk basis, rather than a fully funded basis (as CTC had previously been advised would be the case).

Although CTC was not provided with complete and accurate information, the Review Committee considers, CTC did not apply an appropriate degree of rigour to its consideration of issues relating to the Equity Finance business and the content of the approvals being sought. Further, CTC did not discuss or make enquiries regarding any reputational risk to ANZ associated with the Equity Finance business as was required under their mandate.

The Review Committee considers that CTC should have applied greater rigour:

- in monitoring whether conditions attaching to prior approvals given by CTC had been satisfied;
- in enforcing deadlines for the provision of further submissions, where prior approvals were given on a provisional basis pending delivery of such further submissions.

With the increasing scale of ANZ's business and growing product complexity, particularly in areas of new and non-traditional Institutional banking such as Securities Lending, it is now apparent that CTC needs access to additional capability and resources to analyse critically the proposals put to it and inform its members of the nature of those proposals. This should be supported by further expanding its systems for recording action items and ensuring that there is follow up and review by CTC of action items.

7.7 Inappropriate role of SLORC

SLORC did not have a clearly defined role within ANZ's risk framework. Its charter stated that it derived its authority from CTC. Although CTC had been advised of the proposal to establish SLORC, no formal delegations had been made. SLORC was held out in written submissions to CTC to be the key control body for the Securities Lending business. It did not report back to CTC or to any other committee or person in ANZ. SLORC was chaired by the Head of ANZ Custodian Services.

The Review Committee considers that clearly established lines of responsibility, accountability and reporting are essential to the effective operation of any committee, and that SLORC lacked these characteristics.

In practice, SLORC discussed and considered a wide range of risk and other matters relating to the ANZ Securities Lending unit, but did not proactively manage issues raised with it.

The Review Committee considers that reliance by the line and risk management responsible for the ANZ Securities Lending unit upon SLORC constituted an abdication of individual responsibility by the persons with whom that responsibility should properly reside. That is, responsibility for credit risk should reside with ANZ's Credit Executives, responsibility for market risk should reside with ANZ's Market Risk area and responsibility for day to day management of the business should reside within ANZ's line management structure. While it may be appropriate to have a forum to co-ordinate these responsibilities, ultimate responsibility and decision making authority should remain with the various line and risk management positions.

Finally, the Review Committee considers that SLORC was not effective in fulfilling its self-appointed functions due to a range of factors, including:

- the fact that attendance was weighted in favour of representatives of ANZ Custodian Services;
- inappropriate delegation of attendance by senior market and operational risk representatives to more junior employees;
- poor record keeping and failure to action matters in a timely way.

7.8 Failure to identify warning signs

Various concerns were raised on an ad hoc basis by line and risk managers, generally with their peers and immediate superiors within the Institutional division and with credit risk and market risk managers. These concerns related to the processes, personnel and systems used in the Equity Finance and Standard Securities Lending businesses and the risks associated with these businesses.

The issues that were identified were not consistent with good banking practice and should have prompted further investigation and scrutiny.

The Review Committee considers that line and risk management treated each issue raised on a separate basis and did not consider the cumulative impact of the various issues.

Similar issues were also identified:

- in three reviews of the control environment conducted by ANZ internal audit between 2005 and 2007 for ANZ Custodian Services. The ANZ Securities Lending unit (which formed part of ANZ Custodian Services) was given an adverse or seriously adverse rating as part of each audit;
- by PricewaterhouseCoopers, who were engaged by ANZ in late 2007 to review opportunities to grow the Standard Securities Lending and Equity Finance businesses. That review identified that there were significant control issues in relation to the businesses.

Following the 2005 internal audit review, a remediation program was commenced to address the issues identified in that review. However, relevant remediation actions were not completed in a timely manner, or in a way which ensured that actions taken were embedded into processes so that weaknesses did not reappear (as illustrated by the adverse ratings given in subsequent internal audit reviews).

The Review Committee considers that management did not appear to place sufficient focus on the adverse Internal Audit ratings for the ANZ Securities Lending unit and did not take sufficient, timely and appropriate measures to remedy the underlying issues which were the cause of those adverse ratings although they reported to the Audit Committee that remedial actions were being undertaken.

7.9 Strategy and costs

The Standard Securities Lending and Equity Finance businesses were initially modest in scope but over time grew to become an important source of revenue and profit for ANZ Custodian Services. For this reason, further expansion of these businesses was encouraged or was proposed by the management of those businesses.

However, the Internal Audit reviews of ANZ Custodian Services and other internal ANZ strategy documents identified a need to invest in new technology and other systems to enable the ANZ Securities Lending unit to address existing issues and to accommodate further growth. Decisions to invest were delayed by management or were made with respect to only a portion of the expenditure required.

The Review Committee considers that a decision should have been made to either commit the expenditure required to address existing issues within the ANZ Securities Lending unit or, alternatively, to curtail its operations. It was inappropriate to maintain the business on a growth path without committing sufficient funds on a timely basis to address relevant issues, merely because the business was profitable.

7.10 Knowledge of the Board

7.10.1 Knowledge regarding existence of the Equity Finance business and relevant financial exposures

Between 1999 and February 2008 (ie when serious concerns with some of the Brokers became apparent), papers presented to the Board and the Risk and Audit Committees included only occasional references to the Securities Lending business. There were also a small number of references that included the words ‘equity finance’ or ‘equity financing’. The references could not reasonably have been expected to identify the fact that ANZ conducted an Equity Finance business that was distinct from its Standard Securities Lending business. The Review Committee is not aware of any evidence that this fact was brought to the attention of the Board, relevant Board committees or the Chief Executive Officer in any other manner.

The Review Committee considers that the Board, relevant Board committees and the Chief Executive Officer were not provided with a clear understanding of ANZ’s potential exposures in respect of the Equity Finance business. This was primarily due to the fact that the Equity Finance business initially did not apply credit limits to its customers, and when credit limits were eventually applied they were calculated on a potential exposure risk basis (ie at 10 per cent of the value of relevant transactions). Nor were there adequate reporting lines in place to ensure that potential gross exposures of significant amounts were identified. With two exceptions, the exposures were not identified in reports provided to the Risk Committee.

The exceptions relate to the October 2005 and April 2006 reports to the Risk Committee relating to customers with credit limits greater than those permitted for their internal customer risk grades. These reports noted that one of the Brokers had a credit limit of several hundred million dollars (at this time the limit was shown at 100 per cent of ANZ’s potential gross exposure, as the decision had not yet been taken to classify these limits on a potential exposure risk basis). The Broker was included in a list of 28 customers in the October 2005 report and in a list of 20 customers in the April 2006 report. These excesses were described as resulting from custody ‘stock borrowing’ activities.

These reports were presented in tabular manner which did not draw specific attention to the Broker, and they did not identify the correct nature of the facility to which the exposure related.

7.10.2 Internal Audit Reports

In 2005, an internal audit of internal controls of the ANZ Custodian Services division gave an adverse rating for ANZ Custodian Services generally and a seriously adverse rating for the ANZ Securities Lending unit in particular. The Audit Committee was made aware of the overall rating for ANZ Custodian Services and was provided with a summary of issues. Subsequent updates to the Audit Committee emphasised that remediation of issues identified was progressing. The Board was made aware of these audit findings, but not provided with any detail. For example the Internal Audit segment report to the Board in October 2005 had one line which noted a new adverse rating for ‘Custody, including Securities Lending’.

In the follow-up 2006 internal audit, ANZ Custodian Services was given a satisfactory rating based on the perceived progress made in implementing the remediation program.

In the 2007 internal audit (produced in October 2007) ANZ Custodian Services was given a seriously adverse rating due to concerns that the remediation program was not being implemented as effectively as had been understood during the 2006 Internal Audit. Within this 2007 internal audit, the ‘front office’ of the ANZ Securities Lending unit was given a satisfactory rating and the ‘back office’ was given a seriously adverse rating. In October 2007, the Audit Committee meeting was provided with a paper specifically addressing this audit and was advised that management responsible for ANZ Custodian Services had implemented a remediation program (including the use of external consultants) with respect to the issues raised in the 2007 internal audit. The Audit Committee discussed this paper at some length. The Risk Committee was also advised of the seriously adverse rating of the 2007 internal audit.

The Review Committee considers that the Audit Committee and the Risk Committee were only aware of long-term unresolved issues in ANZ Custodian Services and ANZ Securities Lending unit following the seriously adverse internal audit result in October 2007. Even as late as September 2007, Institutional executives provided comfort in a written report to the Risk Committee about the control environment in certain parts of the Institutional division, including ANZ Custodian Services.

Rectification of the issues identified in the October 2007 internal audit report was superseded in early 2008 by problems crystallising within the Equity Finance business. However, the Review Committee considers that a more structured notification and action system for adverse internal audits should be established in the future.

7.10.3 General matters

The 2005 Securities Lending Review found that the Equity Finance business had not previously been recognised or understood outside ANZ Custodian Services and that, at the time of the review, had an exposure of $771 million and an inadequate control framework. These findings should have been specifically brought to the attention of the Chief Executive Officer and the Board. The Board was made aware of the review, but not any details of the key findings.

However, the Review Committee is not aware of any evidence which suggests that there was a deliberate attempt to suppress adverse information. In other cases, such information was circulated as part of general reporting to appropriate levels within ANZ. Nevertheless, the Review Committee considers that the failure to escalate the issues relating to Equity Finance was, of itself, a significant oversight and requires additional focus to be given to upward reporting practices within ANZ.

7.11 Role of external auditors

ANZ's external auditors, KPMG[1], did not conduct detailed audits of the ANZ Custodian Services business (including the ANZ Securities Lending unit) in the course of their annual audit as these businesses did not fall within the materiality criteria applicable to those external audits.

From 2002, KPMG were specifically engaged by ANZ to prepare a semi-annual statement known as a 1026 statement to review certain ANZ management assurances to the auditors of external funds whose assets are managed by ANZ Custodian Services. Within the limited scope of a 1026 statement, KPMG were only required to consider the extent to which these assertions affected the external funds (not how they affected ANZ). As part of the 1026 statement process KPMG separately advised management of any issues that came to their attention. These included some ANZ Securities Lending unit systems issues which were the same as, or similar to, issues raised in the internal audits.

The Review Committee did not find any evidence that KPMG performed their duties inconsistently with what was reasonably expected.

1 Mr Crawford was a former partner of KPMG and, for this reason, was not involved in deliberations of the Review Committee regarding the role of KPMG.

8 Investigation of breaches of ANZ employee conduct policies

Summary points

No evidence of fraud or other unlawful conduct by ANZ employees was identified.

Five ANZ employees had access to trading accounts with Opes.

The accounts of two ANZ employees had been permitted to remain out of order and, accordingly, the subject of a margin call, for a significant period. These employees breached the ANZ Code of Conduct.

Share trading by two other ANZ employees immediately prior to Opes being placed into receivership did not breach relevant ANZ policies and did not appear to have been conducted for illegitimate or unlawful purposes.

8.1 About the code of conduct investigation

The investigation into Code of Conduct breaches was headed by the ANZ Group Head of Workplace Relations and ANZ Deputy General Counsel for Employment Law together with the ANZ Head of Group Investigations.

8.2 Was there any fraud by ANZ employees?

The investigation did not find any fraud or criminal behaviour on the part of any ANZ employees.

8.3 ANZ employee accounts with Opes

The investigation found that four ANZ employees involved with the Equity Finance business held trading accounts with Opes (as defined in section 1.2). Additionally, one employee's spouse held an account with Opes on which the employee was authorised to trade. The investigation did not identify any other ANZ employees as holding accounts with Opes.

Of these five employees, only one had disclosed the existence of their account to their line manager. Although ANZ's Code of Conduct at that time did not require disclosure by the employees regarding their Opes accounts, the Review Committee considers that it would have been prudent for each of the employees to have disclosed their accounts in the circumstances.

Of the five employee accounts, two were not properly maintained. One employee's account had been out of order and, accordingly, subject to a margin call, since October 2005 with $293,000 owing as at 28 March 2008. The employee had been allowed to trade and increase the account even though it was subject to a margin call. The investigation found no evidence that there had been any follow up action by Opes in respect of the margin call and no attempt was made by that employee to pay the margin call. This employee conducted daily Securities Lending trades with Opes.

The other account had been subject to a margin call since October 2007 with $13,000 owing as at 28 March 2008. The employee had been called on by Opes to bring that account to order in October 2007, but had not done so. No further margin calls were made by Opes, nor did the employee make any attempt to bring the account into order.

The investigation concluded that the two employees with accounts with Opes which remained out of order and subject to margin calls breached the conflict of interest requirements of the ANZ Code of Conduct. They received a benefit from a customer with whom they had an ongoing business relationship, and were in a position to treat that customer favourably (whether or not they did so).

The investigation concluded that these two employees further breached the ANZ Code of Conduct by 'failing to at all times act in the interests of ANZ'. These employees did not bring to ANZ's attention the fact that Opes was not making or enforcing margin calls on clients whose accounts were in margin and allowing clients whose accounts were in margin to continue trading.

As a result of the investigation, these two employees will end their employment with ANZ.

8.4 Trading by employees

Two other employees gave instructions to trade on their Opes accounts on 27 March 2008, the day before Opes was placed into receivership. These instructions were examined and no evidence was found that they were pursued for illegitimate reasons or that the relevant employees were in possession of any relevant confidential or inside information.

The investigation found that:

- The first employee gave instructions to sell ANZ securities immediately prior to the normal half-yearly 'blackout' period during which ANZ employees are prevented from trading in ANZ securities. The instructions provided that unless the transaction could be completed on that day at the specified price it should not be completed until after the expiry of the blackout period. The transaction was not completed.
- The trade by the second employee involved the sale of a small proportion of the total number of a particular security held in the account. The investigation concluded that the fact that the employee gave instructions to sell only a small proportion of their holdings of the relevant security suggests that the employee was not acting on any inside information.

9 Accountability and Remediation

9.1 Themes

The Review has highlighted a need for ANZ to sharpen its focus on business practices and risk management procedures in areas of non-traditional banking within its Institutional division. The remediation actions are directed at reinforcing the following values:

- Encouraging individual accountability;
- Improving risk culture;
- Enhancing the importance of ethics in decisions and actions;
- Acting consistently with strategy.

The remediation actions described below include actions which ANZ has already taken as a result of issues arising out of Securities Lending and additional recommendations proposed following the Review.

9.2 Accountability

This report has identified significant issues within ANZ both in respect of the Equity Finance business and other aspects of ANZ's operations (such as those of CTC). The Review Committee considered the question of accountability. As noted above, none of the Board or Board committees were properly informed of the relevant issues notwithstanding the existence of processes which, if followed, should have led to escalation of the issues to them.

The Review Committee considers that the issues identified in this report were, in essence, a failing of management, both 'line management' and 'risk management'.

The issues concerning the operation of CTC over the years covered in this report ultimately rest with senior management who either participated in CTC or who would have been necessarily concerned with its deliberations (as noted below and in the Executive Summary, the Review Committee believes that CTC should be strengthened with appropriate resourcing to ensure proper follow up and escalation).

The report's findings have led to a series of sanctions in respect of ANZ employees. These sanctions reflect the levels of culpability and seniority of each of the persons affected. The sanctions include formal notes placed on staff employment records, adverse bonus impacts and the departure from the Bank of several managers and executives. Where appropriate, these are the subject of a separate public announcement by ANZ.

9.3 Remediation actions

The remediation actions to be taken by ANZ are set out below.

9.3.1 Exit Equity Finance

The Chief Executive Officer has already directed that ANZ withdraw from all Equity Finance business in an orderly manner and rationalise all Standard Securities Lending business to a few key multinational institutional relationships.

9.3.2 Disciplinary Actions

As a result of the Review a number of disciplinary actions will be implemented. The employees involved range throughout many levels of ANZ. Some former employees would also have been subject to these actions if they were still at ANZ.

9.3.3 Code of Conduct and Ethics Policies

ANZ is refreshing all of its employee code of conduct, ethics and conflict of interest policies. This includes development of a new computer based training module covering key areas such as Privacy and Conflict of Interest and implementing an annual attestation for each employee that they understand the key policies and have complied with them. ANZ will also place a prominent link to the above policies on the front page of ANZ's staff intranet and ensure the issue is reinforced through line management communications.

9.3.4 Reputation Risk Framework

ANZ Group Compliance is implementing a new reputation risk framework to clarify what reputation risk is at ANZ, confirm ANZ's reputation risk policy and set clear accountability across ANZ for management of reputation risk.

9.3.5 Performance Management Framework

ANZ Human Resources is creating a new Performance Management framework which will reinforce individual accountability through better role clarification and will take into account any compliance or control breaches in determining final ranking and subsequent bonus allocation.

9.3.6 Training for ANZ Senior Executives

All ANZ senior executives will attend a training session covering areas such as escalation of problems, the new Code of Conduct and case studies that emphasise ANZ's values and people management policies.

9.3.7 Change the fundamentals of committees

The structure and reporting lines of management committees (including CTC) will be reviewed. This will ensure all committees have clear authority, guidelines, mandates to perform specific functions and accountabilities for performance and failures to perform. This review will also include the form of submissions and the process for recording follow up actions and decisions.

9.3.8 Internal Audits and significant operational control issues

ANZ will introduce more rigorous management of businesses with adverse Internal Audit ratings and operational control issues identified as 'high' including:

- additional responsibility for ANZ Management Board to oversee remediation and ensure that there are procedures in place to implement follow-up and provide incentives for good governance;
- the manager of a unit subject to a seriously adverse rating or repeated significant operational control issues will present to the ANZ Management Board meeting and Audit Committee meeting on proposed actions;
- the Group General Manager for Internal Audit, and an External Audit firm representative will attend every Audit Committee and Risk Committee meeting;
- continual reporting of audit issues to the ANZ Management Board, Audit Committee and Risk Committee and highlighting adverse audits and their remediation and poor remediation of other audits.

9.3.9 Product Management

There will be a full review of the product approval process in ANZ.

9.3.10 Review classification of facilities

ANZ will develop an annually reviewed central register of the credit limit classification of all Institutional division products. The methodology for the percentage applied to potential exposure risk facilities should be included on the register. Any changes to classifications are to be hindsight reviewed by the Chief Risk Officer or his delegate.

9.3.11 Customer exposure reporting

ANZ will improve exposure reporting for its senior risk and line management that monitors both size and movements in customer activity.

9.3.12 Exposures without limits

Business unit Managing Directors (and their relevant IT support areas) will review their businesses to confirm there are no other areas with processes and systems which might permit potential drawdowns without proper arrangements in place. Any weaknesses are to be reported back to Chief Risk Officer with details of mitigating controls in place.

9.3.13 Wholesale Credit Risk Policy

There will be a full review of the development and dissemination of the ANZ Wholesale Credit Risk Policy.

9.4 Next steps

ANZ will fully co-operate with its regulators in relation to a detailed program to implement the remediation actions mentioned above including the responsible persons and timeframes. We will also keep our regulators regularly informed of progress of such actions.

National Consumer Credit Protection Bill 2009 and *National Consumer Credit Protection (Transitional and Consequential Provisions) Bill 2009*

Exposure Draft

Submission to the Treasury

May 2009

INTRODUCTION

Australia and New Zealand Banking Group Limited ('ANZ') is pleased to provide comments on the *National Consumer Credit Protection Bill 2009* ('the Bill') and the *National Consumer Credit Protection (Transitional and Consequential Provisions) Bill 2009* ('the Transitional Bill').

The Bills establish national regulation of consumer credit. They also make a number of changes to the current regulation of consumer credit, including introducing a national credit licensing regime for anyone providing a credit service. A range of obligations are imposed on licence-holders including responsible lending obligations. The responsible lending obligations set in place expected standards of behaviour of licensees when they enter into consumer credit contracts or where they suggest a credit contract to a consumer or assist a consumer to apply for a credit contract.

These Bills will have a major effect for the way anyone who provides credit services does business. ANZ has a number of concerns about the way the legislation will operate in practice. We will also need to make changes to comply with the legislation. A longer transition period is necessary to enable ANZ to do this.

1. TRANSITIONAL ARRANGEMENTS AND TIMEFRAMES

LIC150 of the Bill and Schedule 1 of the Transitional Bill set out a two-phase licensing process. Credit providers will need to register with ASIC before 1 January 2010 and then must apply for an Australian Credit Licence (ACL) by 30 June 2010. Our interpretation of the Bill is that, from 1 January 2010, ANZ would need to comply with all the obligations of a licensee. In addition, from 1 November 2009, all credit providers must comply with the National Credit Code, which extends the Uniform Consumer Credit Code's coverage to residential investment loans.

This legislation has been in development for some time and there has been involvement from some key stakeholders. However, confidentiality agreements have prohibited discussion with ANZ's businesses about the Bill's effect on specific credit products and processes. The first opportunity to do this was when the legislation was released on 27 April 2009. The short timeframe for public comment has made it difficult to consider all the implications of the legislation for ANZ.

Furthermore, the two-phase process announced by the Minister for Superannuation and Financial Services suggested that credit cards would be dealt with in the second phase. The Bill has significant implications for credit cards, which is a widening of the scope of the Bill from what we had expected.

The wider scope and short timeframes will present significant challenges for ANZ. There are a range of areas where ANZ will need to make changes or fulfil requirements to enable compliance with the full range of licensing obligations.

i. Systems and process changes

ANZ will be required to undertake major systems and process changes to:

- change existing forms and documents (including system generated forms and documents as well as printed and online versions) and develop new forms (such as the direct debit failure notice) for all our consumer credit products;
- meet record-keeping obligations;
- collect new information from customers (eg their requirements and objectives) and ensure this is appropriately recorded and retained on our systems (as you would appreciate our systems do not currently include fields where this information can be clearly captured);
- cover new products: residential investment property loans and margin lending (which is covered in a separate bill but nevertheless has the same timing as this legislation);
- revise contract documents (letters of offer which are system generated and printed terms and conditions booklets) for residential investment properties to ensure they meet the new obligations in the National Credit Code. Changes to IT systems for system generated documents will need a reasonable lead time; and

- train our staff so they are aware how to carry out an 'assessment' that a credit product is 'not unsuitable' for the customer (particularly in relation to the review of requirements and objectives) and when it is reasonable to request additional information.

It will be impossible for ANZ to make these systems and process changes before 1 January 2010. In particular, this is made more difficult by the need to freeze any systems changes in from December to mid-January to ensure we can meet additional seasonal demands on those systems over the Christmas/New Year period.

ii. Training

ANZ will need to ensure that its representatives are adequately trained and are competent to engage in credit activities. A large number of ANZ staff who provide 'credit assistance' would need to be trained. Initial estimates suggest that we would need to train at least 2,500 staff, which will include branch staff located in metropolitan as well as regional and rural areas. This would take at least 9-12 months.

A further issue is that the standard of training is yet to be determined by ASIC. It is difficult to advise on the extent of the impact of this measure without further guidance on the expected level of training. This advice should be provided as soon as possible after consultation with key stakeholders. We consider it is not necessary for representatives for credit purposes to have the same level of training as is required under the FSR regime. They are completely different activities with different incentives, risks and skill requirements. We do not believe Tier 1 level training is required in this case.

iii. Other requirements likely to impact on timing:

There are also a number of other factors which will affect ANZ's ability to meet the proposed timeframe. These include:

- Risk assessment and contractual arrangements for intermediaries (brokers/franchisees etc) which ANZ may wish to appoint as credit representatives. ANZ has relationships with 80 home loan brokers (aggregated groups), 240 franchisees (for example, mobile lenders), 300 car loan brokers and 350 car dealers who sell ANZ car loans;

- Other new regulation with which we will also need to comply (eg margin lending, unfair contracts, the second phase of credit regulation); and

- Engagement of any additional staff we may require to undertake additional verification of customer's financial details.

Previously when similar legislative changes have been made (eg FSR, introduction of the UCCC), transition periods of two years have been provided. This allows licensees to make the changes necessary to comply with minimal disruption to business.

At this stage, ASIC guidance is expected to be provided on training standards and credit assessment. A transition period would ensure that this guidance is available and can be implemented and clarification sought where necessary. A timetable of expected guidance and when it will be provided by ASIC would be useful in transition planning. It would also be useful for there to be effective consultation with credit providers and other stakeholders in the development of the ASIC guidance.

Given the extensive obligations, the need to ensure all consumer credit products are compliant and the systems changes required, a two-year transition period should be allowed before the legislation comes into effect.

2. RESPONSIBLE LENDING

The draft legislation introduces new responsible lending provisions. This is a significant new legislative obligation for credit providers. Broadly, before a consumer enters into a credit contract (including a limit increase) or remains in an existing credit contract based on ANZ's advice, ANZ must:

- provide the consumer with a Credit Guide (unless the consumer has already received one)
- make an assessment as to whether the credit facility or increase in credit limit is not unsuitable for that consumer having:
    - reasonably inquired about the borrower's requirements and objectives;
    - reasonably inquired about the borrower's financial situation; and
    - taken reasonable steps to verify the borrower's financial situation.

Credit must be deemed unsuitable (and must not be provided) if it is likely that the:

- consumer could not comply with all financial obligations of the contract or could only comply with substantial hardship; or
- the product does not meet the consumer's objectives.

The above process must include an assessment of capacity to repay. The assessment of capacity to repay must be made at the time of application for credit. In relation to residential investment loans, the circumstances in which ANZ can take into account anticipated rental income are unclear (noting that the UCCC did not extend to mortgages over investment properties). We believe it is appropriate to include rental income and our policy is to do so conservatively by taking into account a portion of the expected rent stream. Further, the implications of this assessment model where the consumer intends to negatively gear their investment property are also unclear.

The responsible lending obligations may affect ANZ's ability (and the ability of all other financial institutions) to offer certain credit products which may have a negative impact on the ability of some sectors of the community to access credit at a reasonable cost. For example, low documentation loans which are traditionally available to self employed persons will be affected because ANZ may be unable to satisfy obligations around "reasonable inquiries about financial situation" and "assessment of unsuitability". While documentation can be produced in respect of previous years' tax returns, this still would not, in our view, comply with the requirement to verify capacity to repay as previous income is no guarantee of future income.

It should not be assumed that all low documentation mortgage loans are of a lower credit quality or that applicants for such loans cannot comply with the financial obligations under the loans. ANZ's LoDoc60 loan, which is around 20% of our total home loan book, requires a loan-to-value ratio of at least 60% (ie 40% deposit). This loan product had a 90-day delinquency rate of 0.28% compared with 0.4% for our total home loan portfolio as at April 2009. This lower delinquency rate has been a consistent trend for these loan products. For self-employed people, low documentation loans offer mortgage financing which may otherwise not be available or is available at higher interest rates or costs. ANZ's low documentation mortgage loans are offered on the same terms and interest rate as ANZ's standard variable rate home loans. It is not clear whether the Government intends these products to be removed.

ANZ's responsible lending promises

We believe that we are already meeting the obligations of a responsible lender. In 2005, ANZ was the first Australian bank to introduce responsible lending promises. These responsible lending promises are part of our Customer Charter, which sets out benchmarks for service to personal and small business customers. Our performance against these benchmarks is reviewed annually by an external auditor and the results published.

Under these responsible lending promises, ANZ credit card customers will not receive an unsolicited credit limit increase offer if they:

- Have repeatedly been overdue in making repayments or only made minimum payments in the previous six months
- Have an ANZ account receiving Government benefits (including Centrelink and Department of Veterans Affairs).

As a result of the introduction of these promises, the pool of customers who would have otherwise received a credit limit increase offer reduced by around 11 per cent.

Other promises we made about responsible lending are to:

- Provide information about easy and efficient ways to reduce your credit card limit
- Ensure the minimum monthly credit card repayment does not fall below 2% of the outstanding balance, unless the customer:
    - Is in financial difficulty and we are assisting with reduced repayments
    - Has accepted a special offer where for a specified period either no interest or a concessional interest rate is charged and no repayment is required
- With any credit card limit increase offer:
    - Outline how much the minimum monthly repayment would increase if the offer was accepted
    - Recommend the offer be rejected if personal circumstances have changed
    - Include information about how to request a lower offer

- Explain in clear and simple terms how interest on a credit card or loan is calculated and charged, what fees may apply and when, and the consequences of late credit payment

- Respond within 48 hours to customers who have contacted us by telephone, and within five days to customers who have contacted us by letter, to advise us of financial hardship. We may also refer a customer to an accredited financial counsellor.

Our responsible lending promises are a practical response to research we undertook on financial literacy. This research found that there are three core factors which cause people to fall into financial difficulty:

- ‘unhealthy’ ways of thinking about personal finances;

- circumstances outside of people’s control; and

- lack of financial skills and knowledge.

Financial difficulty is most often caused by a combination of these factors, however the first two dominate as the causes of financial difficulty. These attributes of the consumer are difficult to determine by asking them for more details about their financial status.

The Bill should impose limited additional obligations on responsible lenders such as ANZ. However, as drafted it is not clear this is the case. The credit assessment processes required under the legislation should reflect those of credit providers who are already responsible lenders.

Credit assessment methodologies

ANZ believes that the most appropriate credit assessment method differs depending on the stage of the customer’s relationship with a credit provider. It should also be a judgement based on the risk of the customer and the product. We apply a rigorous process which results in many applications being declined. As an example, applying our credit assessment methods, in April 2009, 46% of credit card applications were declined.

We currently treat established customers differently to new customers. This is appropriate given the information we have on established customers’ financial performance over time. More information based on actual credit behaviour reduces risk in decision-making and this should be reflected in the principles relating to responsible lending. The Bill, however, applies the same approach to all customers, whether they are new or established.

Assessment of customer-provided financial information is the most appropriate method to properly assess new applicants for credit where there is a lack of any other information held by the credit provider. ANZ does not generally rely on behavioural scoring of a customer to assess capacity for a credit card limit increase offer until that score can be based on nine months of the customer’s transactional and repayment data. Where ANZ has built up information about a customer's credit behaviour over this timeframe, automatic scoring is a highly reliable technique to assess further credit applications. This is demonstrated by analysis we've previously undertaken as set out below.

ANZ conducted a study in 2005 into the credit behaviour of a group of recently acquired credit card customers who were approved based on an assessment of their self-reported financial details compared with a group of existing customers who had accepted a credit limit increase offer and were assessed using ANZ's credit scoring methods. Over a six month period, 1.7 per cent of the first group of customers showed signs of financial stress (for this analysis, financial stress was defined as being 30 days late on a payment for one or more occasion). During the same period, only 0.6 per cent of those assessed by behavioural scoring displayed signs of financial stress. More rigorous assessment processes are unlikely to reduce this small group who experience financial stress.

In 2005, we commissioned research, published by AC Nielsen, into financial difficulty (available at www.anz.com/about-us/corporate-responsibility/community/financial-literacy-inclusion/research/). This showed that financial stress is more likely to be related to unexpected changes in circumstances than inadequate assessment processes.

ANZ conducted a further analysis of the ANZ customer base in the ACT to assess the reliability of credit assessment based on financial information provided by a sample of customers.[1] The results of this analysis suggested that legislation in the ACT, which requires that all credit limit increase applications be assessed through manual assessment methods, has not reduced the rate of defaults.

ANZ's responsible lending commitment on unsolicited credit limit increase offers, as discussed above, does not involve the collection of additional financial information from our customers but instead adds to our standard credit assessment process which relies on the information held by ANZ and behavioural scoring. It does not require ANZ to obtain additional information directly from the customer in relation to a credit limit increase offer as the ACT's regulation does. As discussed above we believe behavioural scoring is a reliable way of measuring the likelihood that a consumer will get into financial difficulty and default on the credit contract.

ANZ uses two measures, the receipt of Government benefits and consumer behaviour over a period of time, as a proxy to identify the customers most vulnerable to financial difficulty. While this may not exclude all vulnerable customers, it represents the most reliable and effective measure available to us. Additional information sourced from the

[1] ANZ conducted the analysis on the ACT because in 2002 this Territory introduced obligations on credit card providers to ask existing customers for new information on income and expenditure to assess manually whether a credit limit increase could be granted, rather than relying on the automated behavioural scoring tool developed and used by banks (see section 28A of the *Fair Trading Act 1992* (ACT)).

customer is unlikely to identify vulnerable customers any further — such as those who may face future employment instability or other changes to their circumstances.

The Bill as currently drafted places value only on verification of customer provided data. It does not appear to place any value on the data already held by credit providers on existing customers. We submit that at the very least ‘reasonable steps’ should include reliance on existing data and behavioural scoring.

Positive credit reporting

The process imposed in the legislation could be more easily implemented if ‘positive’ credit reporting were available. Australia has a ‘negative’ credit reporting system which basically collects information on whether a credit provider has sought a credit report in connection with an application for credit, and reports of default, court actions and bankruptcy.

While this information is useful in some instances, such as when deciding to approve a home loan, it may not add as much value as other sources of information, such as behavioural scoring, when approving a credit limit increase.

The Australian Law Reform Commission (ALRC) has examined the credit reporting system. In its report *For Your Information: Australian Privacy Law and Practice*, the ALRC recommended that ‘there should be some expansion of the categories of personal information that can be included in credit reporting information held by credit reporting agencies’ including:

- The type of each current credit account opened (eg mortgage, credit card, personal loan);
- The date on which each current credit account was opened;
- The credit limit of each current account; and
- The date on which each credit account was closed.

Such a system would enable credit providers to identify reliably a customer’s existing liabilities and previous credit performance. We believe that the responsible lending obligations contained in the Bill should commence once the positive credit reporting system is available to lenders.

Credit assistance and credit providers

We are concerned about the application to credit providers of responsible lending conduct expected of credit assistants under Part 3-1 of the Bill. We believe these standards predominantly relate to brokers and other intermediaries. The application to credit providers does not reflect the way they conduct their credit business. In addition, given that the lender must comply with these obligations before the credit is provided in any case, it is not clear what value is gained by imposing these obligations earlier in the process. The assessment applied at this later time removes the need for a preliminary assessment to be done at the assistance stage. Licensees who are credit providers should only be required to comply with the responsible lending conduct obligations under Part 3-2 of the Bill.

ANZ must make a preliminary assessment as to whether the contract will be unsuitable for the consumer prior to any credit assistance being provided. 'Credit assistance' includes assisting the consumer to apply for a particular credit product with ANZ. The product application form is the means by which ANZ collects information from the customer about their financial situation and may also collect information about the customer's objectives and requirements. The proposed requirement in R150 means that where a customer has deliberately chosen the product they want and wish to apply for it, our staff cannot assist the customer with the application until the assessment of unsuitability has been performed (ie the assessment must be performed at a time prior to having obtained the information in the application form which will allow the assessment to be made).

Additionally, given the types of queries received from customers and potential customers, we are concerned that some activities undertaken by our staff may amount to inferred or implied suggestions for a particular product which would constitute ‘credit assistance’. For example, a person may request an indication of the amount they would be eligible to borrow in circumstances where they are not yet ready to make a formal application. As part of this process, the person may be given an indication of the likely repayments for that loan amount based on ANZ’s standard variable rate at that time. This may amount to a suggestion that the person apply for the ANZ Standard Variable Rate home loan.

Online tools which recommend the loan that best suits the customer based on the preferences entered, would also constitute ‘credit assistance’ (an example can be viewed at http://www.anz.com/aus/calculators/default.asp then under the heading ‘Help me select a home loan…’). In this situation, although information about the customer’s objectives and requirements is requested in order to be able to make the recommendation, it is premature and unnecessary to collect information about the customer’s financial situation. Often a customer will use these tools as a means of researching what is available and may not wish (at that point) to make a formal application (or have not yet chosen ANZ as their provider).

The use of tools such as these is initiated by the customer. The purpose behind these tools and the ease and simplicity of using them would be compromised if ANZ were required to collect information about the customer’s identity and financial information and have to verify this information before the results from the tool could be provided. At the moment any person is able to use these tools as a reference and to do so without providing their name and details. We submit that the point at which a lender should make an assessment of the customer’s financial information and unsuitability is once the customer has applied for a loan. To have to conduct a preliminary assessment earlier in the process confuses the role of lender with an intermediary.

Recommended credit assessment process

We believe reasonable steps to take in relation to capacity to repay for credit contracts should vary depending on the product and the customer, including the extent of the customer's relationship with the provider. The differences in the way ANZ treats new and established customers are outlined above. These processes are effective and we do not believe the legislation should impose substantial additional obligations on responsible lenders such as ANZ. However, as drafted we believe it does, particularly in relation to the provision of 'credit assistance'.

A risk-based approach to credit assessment is appropriate and delivers good outcomes. Highly prescriptive regulation on credit assessment is unlikely to improve these outcomes as most defaults are associated with unexpected circumstances rather than inadequate assessment processes. It should be made clear in the Bill, or at least in the Explanatory Memorandum, that a risk-based approach is acceptable with the level of assessment undertaken based on both the risk of the customer and the risk of the product.

Furthermore, for established customers, behavioural scoring is a reliable way to determine capacity to pay. In fact, our research shows it is more reliable than additional checks on an individual because capacity to pay relates to how a consumer intends to use the product as much as the level of their income and other liabilities. Behavioural scoring provides this information. The Bill should make clear that behavioural scoring has an important role in assessing capacity to pay for established customers.

3. OTHER ISSUES

Direct debit failure notices

Credit providers will be required to give a debtor (and any guarantor) a one-off direct debit default notice (ie the first occasion of default for a particular credit contract) within ten days of the default occurring. ANZ's existing systems and processes currently intervene after 14 days. One of the main reasons for allowing more time is that in many cases the customer will self-correct the failure. A notice in these instances would be unnecessary. A notice period of 10 business days (or 14 days) would address this concern. It would also bring the notice period into line with other notice periods in the Bill.

Copy of assessment on request

A consumer has the right to request a copy of the assessment that sets out the determination that the proposed or existing credit contract is not unsuitable for them, and the grounds for that assessment. This can be requested up to 12 months after the credit contract expires and must be provided within two days of the request.

It is not clear from the draft legislation what information needs to be set out in the assessment documentation provided to the consumer. We would obviously not wish to disclose commercially sensitive information due to the increased fraud risk associated with providing this type of information to consumers.

It will also be impossible for ANZ to meet the two-day deadline. If a notice is posted it may take longer than two days for the consumer to receive it. A period of 10 business days would be achievable.

Dealing with intermediaries

Licensees are prohibited from dealing with unlicensed parties in relation to a credit contract. A criminal penalty, including imprisonment, or a large civil pecuniary penalty could be imposed for breaching this. Licensees need up to date information about changes in licensing of brokers and other intermediaries to be able to undertake checks and protect themselves from liability. To address this problem, ASIC should maintain a public licensing register. However, with the volume of transactions that ANZ undertakes with brokers, it would be extremely burdensome to check the register each time we deal with a broker. ASIC should ensure that licence revocations are widely publicised. Licensees should be able to register with ASIC to receive notifications of licence revocations and other changes.

Conflicts of interest

Licensees must have in place adequate arrangements to ensure that customers are not disadvantaged by any conflict of interest that arises in relation to its credit activities or those of its representatives.

We submit that there are some areas of uncertainty in relation to the operation of this proposed obligation, including:

- we note from the commentary that the intention is that this relates only to conflicts of interest that arise at law. This limitation is not reflected in the provisions as they are currently drafted;

- a person can be a lender's representative if it can be said that they are *acting on behalf of* that lender (licensee). This could be the case in respect of one aspect of the credit activity, for example, performing the customer identification for the lender. But in all other respects, the person is the agent of the customer. In this situation, if the person is a licensee in their own right, both this person and the lender as licensees would have to comply with the conflicts obligation. The practical application of this obligation is unclear in these circumstances for the lender. For example, is the person taken to be the representative of the lender generally (despite also being the customer's agent) so that the lender needs to ensure that all aspects of the person's relationship with the customer do not lead to disadvantage or conflict for the customer; and

- it is not clear whether it is intended that a licensee can be the *representative* of another licensee (the 2nd licensee) by virtue of that first licensee *acting on behalf of* the 2nd licensee.

Further to this, variations in commission structures received by intermediaries from different lenders may also be regarded as a conflict with the interests of consumers. Again, given the broad wording of 'acting on behalf of' which appears in the definition of 'representative', it may be that an intermediary will be held to be ANZ's representative. In this case, ANZ is not privy to commissions a broker may receive from other lenders. This makes it very difficult to ensure a customer has not been affected by a broker’s conflict of interest.

Securitisation

DEF 9 provides that an assignee of a credit provider, lessor, etc is itself a credit provider. This means the assignee would need to be licensed and because of R232 provide a credit guide.

Securitisation and other financial techniques involve assignments of beneficial interests. It should be made clear that DEF 7 only applies to legal assignments (ie where the lender of record changes). Unless this change is made, securitisation and other funding arrangements will be compromised and consumers will receive many confusing notices.

4. PENALTIES

The proposed penalties for breaching the legislation are significant:

- criminal penalties, including imprisonment for up to 5 years; and
- fines, and compensation to consumers for loss or damage suffered.

These are in addition to the remedies and penalties applicable under the Code.

Imprisonment is available as a penalty for many of the criminal offences. Some of these include failures to provide information or notification to ASIC. We believe a penalty of imprisonment is too severe for such offences. There is likely to be little public harm associated with an offence of that nature. For example, failing to notify ASIC of an authorised representative is unlikely to directly cause major public harm. A criminal penalty, which has significant effect beyond just the imprisonment or monetary fines imposed, is unnecessary to protect the public.

We believe it is important that, as part of the licensing regime, licensees meet certain obligations. We are not opposed to this happening where it results in improved regulatory outcomes. A large civil penalty should be a sufficient deterrent to obtain this outcome in relation to failures to notify or provide information.

There are examples where criminal penalties may be appropriate. These should be limited to instances where a credit provider has knowingly or intentionally offered a consumer a credit contract which is detrimental for that consumer. For example, a property investment adviser who sells properties and provides finance, knowing they will benefit from fees associated with the credit contract and then repossess the house when they can no longer pay.

LIC275 includes a strict liability offence for which imprisonment is available. This is inconsistent with standard penalty practice and should be revised to a more appropriate penalty.

5. CONCLUSION

ANZ supports regulation in areas where regulation has been unsatisfactory eg mortgage brokers, fringe lenders. The Bill as drafted currently has major implications for the way ANZ conducts its credit and lending businesses.

We will need further clarity on some provisions. In some cases this will come in ASIC regulatory guides. The legislation and regulatory guides will require changes to ANZ's systems and forms, additional training for a large number of staff and various other transitional adjustments. A two-year transition period, as was provided for FSR and the UCCC, should be provided in this legislation.

As discussed above, we believe that the most appropriate credit assessment method differs depending on the stage of the customer's relationship with a credit provider. It should also be a judgement based on the risk of the customer and the product. To clarify that this is permitted within responsible lending obligations we would like it to be clear in the Bill that:

- a risk-based approach is acceptable with the level of assessment undertaken based on both the risk of the customer and the risk of the product; and
- for established customers, existing customer information, including behavioural scoring, is a reliable way to determine capacity to pay.

ANZ would be pleased to provide any further information about this submission as required, and can be contacted as follows:

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Financial Services and Credit Reform

Green Paper

Submission to the Australian Treasury

July 2008

1. MORTGAGES, MORTGAGE BROKING AND NON-DEPOSIT TAKING INSTITUTIONS AND OTHER CREDIT PRODUCTS

The Green Paper suggests that the Commonwealth proposes to assume responsibility for mortgages, including associated advice, by incorporating this type of credit into the financial services provisions under Chapter 7 of the *Corporations Act*.

ANZ supports the national regulation of credit and believes it should not be limited to just mortgage lending and advice, but cover all forms of credit, including credit cards and personal loans, as was recommend by the Productivity Commission's (PC) final report on the Review of Australia's Consumer Policy Framework. Further, the method of regulating credit at a national level should be to retain the Uniform Consumer Credit Code (UCCC) as a self standing set of requirements within the broader financial services regime, and this was also supported by the PC.

<u>Why should all credit be regulated at a national level?</u>

The market for credit, including mortgages, credit cards and personal loans is now national with consumers shopping for these products without regard to State and Territory borders. This shift to a national market for credit has been facilitated through greater use of internet banking, phone banking as well as the availability of online applications. For example, a customer can apply for an ANZ credit card or personal loan over the Internet, or customers can shop for the same products at any of our over 820 branches located all around Australia.

The Green Paper suggests two reasons why the Commonwealth Government is considering limiting the national regulation of credit to mortgages:

- Firstly, mortgages represents the overwhelming majority of the consumer credit market at 86 per cent of all consumer loans by amount; and
- Secondly, that there may be a legitimate and ongoing role for the States and Territories to continue regulating other forms of credit because the use of credit facilities may be affected by regional differences which may need to be accounted for in the regulatory regime applying to these products.

While mortgage lending does represent the vast majority of the credit market by volume, it is also important to recognise that the average Australian consumer is more likely to hold credit products such as a credit card or personal loan, rather than a mortgage. According to data from the Roy Morgan Research Finance Monitor, in March 2008 there were 10.125 million credit card customers, 2.062 million personal/other loan customers and 5.176 million mortgage customers.[1] Based on this

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[1] Sourced from data compiled by Roy Morgan Research Finance, as per ANZ Quarterly Management Definitions

data, mortgage customers represent less than 24 per cent of the Australian population[2],[3] compared to 48 per cent of the population who hold at least one credit card. So in the event that the Commonwealth simply regulated mortgage credit it would cover a significant portion of the market by dollar value, but would protect only a relatively small portion of the Australian population who purchase credit products.

While there is currently variation in the regulation of credit between jurisdictions, ANZ believes that this is largely a result of State and Territory Governments using their fair trading legislation as a means to drive consumer protection initiatives which do not have national support. It has not resulted from the need to adapt to regional differences as suggested by the Green Paper.

An example of how one jurisdiction is circumventing the intention for there to be one uniform set of credit regulation under the UCCC was the introduction of new obligations for credit card limit increase offers in the Australian Capital Territory (ACT). In 2002 the ACT introduced obligations on credit card providers to ask existing customers for new information on income and expenditure to assess manually whether a credit limit increase could be granted, rather than relying on the automated behavioural scoring tool developed and used by banks.

ANZ's analysis of our credit card customer base has shown consistently that behavioural scoring is a significantly more reliable assessment method than manual assessment of a customer's financial information. The major weakness of manual assessment is that it relies on the accuracy and currency of information provided by customers as opposed to a behavioural history.

The ACT's amendment does not reflect an attempt to address specific regional differences and puts it out of step with other jurisdictions. It added a further step to the process of granting a customer a credit card limit increase and for a relatively small segment of ANZ's customers. This has added costs and reduced efficiency but not for a discernable customer benefit.

The chart below shows credit card delinquency rates for the ACT compared with the rest of Australia. While data for the ACT is more volatile than the rest of Australia due to the small population, the chart shows that credit card delinquency rates in the ACT have generally moved almost identically to the rest of Australia. This suggests that the ACT's credit limit increase restrictions have had no observable impact on ACT residents' credit performance.

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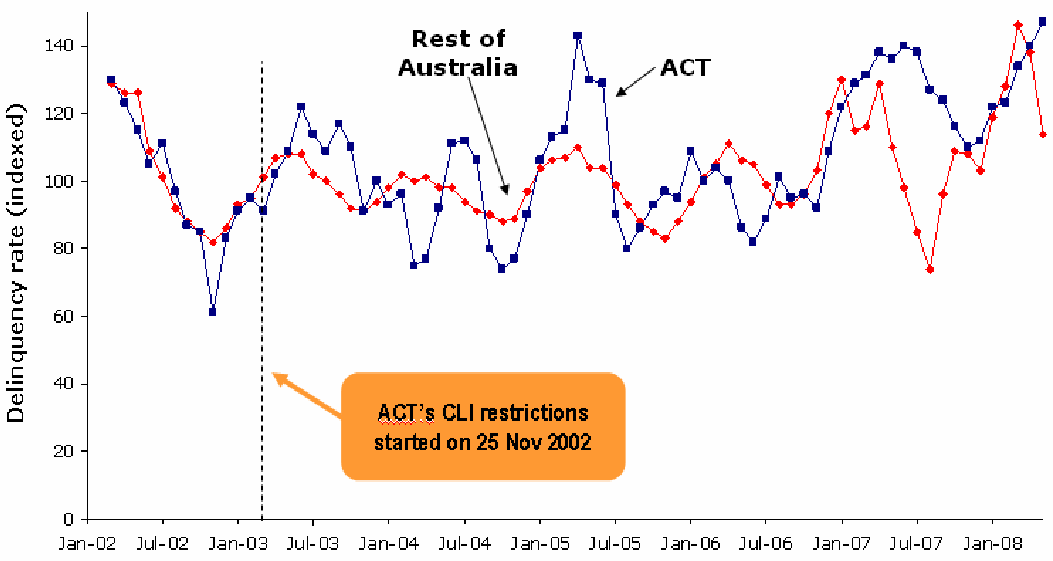
2 Estimate of the Australian population as at end December 2007 is 21.1086 million

3 Australian Bureau of Statistics, *3101.0 Australian Demographic Statistic—December 2007*, 24 June 2008

Delinquency rates of ANZ credit card customers in ACT and rest of Australia



Note: Delinquency rates show the percentage of customers 90 or more days past due in the last 12 months. Data for ACT and Rest of Australia has been indexed to give an average of 100 for 6 months prior to November 2002.

Source: ANZ Bank - Credit Cards Australia

On the basis of the information above, ANZ believes that the reasons outlined by the Green Paper alone are not sufficient to justify a carve-out of specific areas of credit to remain with the States and Territories.

If the Commonwealth Government selectively regulated some credit and left other areas with the States and Territories, ANZ and other credit providers would be subject to increased regulatory burden. Credit providers would face differing regulatory regimes for specific types of credit and credit would have nine regulators and policy makers as opposed to the current eight.

Moreover, leaving regulation of credit cards and personal loans with the States and Territories would do nothing to rectify the existing shortcomings of the UCCC. The UCCC has been widely criticised for its inability to adapt to changes in the market place in a timely manner, which has resulted in gaps in its coverage. Examples of this are responding to issues such as bills of exchange and the regulation of finance brokers.

Finally, ANZ notes that in recommending that the regulation of credit be transferred to the Australian Government, the PC final report on its Review of Australia's Consumer Policy Framework stated that the new national credit regime should "*cover all consumer credit products and all intermediaries providing advice on such products…*".[4]

[4] Productivity Commission, *Review of Australia's Consumer Policy Framework—Final Report*, 30 April 2008, p. 107

How should credit be regulated at the Commonwealth level?

Should the Commonwealth Government choose to regulate some, or all, areas of credit at a national level, ANZ believes that this should be done in the manner proposed by the PC in its Final Report on the Review of Australia's Consumer Policy Framework.

Recommendation 5.2 of that report stated that responsibility for the regulation of credit providers and intermediaries providing advice on credit products should be transferred to the Australian Government, with enforcement undertaken by the Australian Securities and Investments Commission (ASIC).

However, rather than regulating credit under Chapter 7 of the *Corporations Act* the PC recommended that a new national credit regime should "*retain the Uniform Consumer Credit Code (UCCC) as a self standing set of requirements within the broader financial services regulatory regime…*".[5]

ANZ supports this recommendation because of the differences between credit and other financial services. As noted by ASIC in their submission to the PC's Draft Report on its review of Australia's Consumer Policy Framework:

"*The consumer and compliance risks that arise in the context of credit products are different from, and in many respects less significant than, the risks to retail investors arising from investment products. A consumer who enters a credit contract holds the lenders funds and makes long-term promises to repay in the future, with interest. In contrast, when a retail investor acquires an interest in an investment product, it is the product provider that holds the investor's money and makes the long-term promises about its management and repayment. In addition, with investment there is a very large range of different permutations of risk, cashflows, taxation, capital appreciation and potential financial loss for the investor to consider.".* [6]

Chapter 7 of the *Corporations Act* focuses on disclosure and the adequacy of training for those providing advice to ensure that a customer is aware of the risk associated with particular financial products. On the other hand, the UCCC has a core focus on 'truth in lending' and informing consumers about the terms of a credit contract (including interest rates, fees and charges) prior to its purchase. As such, ANZ believes that it is important that these differences are maintained in any transition of the regulation of credit to the Commonwealth.

ANZ is also concerned that the industry, and therefore consumers, do not incur additional compliance costs as a result of a transfer of regulation to the

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[5] Productivity Commission, *Review of Australia's Consumer Policy Framework—Final Report*, 30 April 2008, p. 107

[6] ASIC, *Productivity Commission Review of Australia's consumer policy framework: Second ASIC Submission*, February 2008, p. 7

Commonwealth Government, and this method would ensure that transitional and ongoing compliance costs for industry are kept to a minimum.

2. TRUSTEE CORPORATIONS

ANZ Trustees Limited (ANZ Trustees) is a wholly owned subsidiary of ANZ. As a statutory trustee company, ANZ Trustees is authorised to act under the trustee company's legislation of each Australian State and Territory (except Tasmania) as:

- An executor of Wills;
- A trustee of charitable and non-charitable foundations;
- A trustee of statutory common funds;
- An investment manager of common funds and foundation assets; and
- A provider of other trustee services.

ANZ Trustees provides services in estate planning, trustee management, asset management and administration to a broad range of Australian individuals, corporations and charitable institutions.

As one of the leading trustee organisations in Australia, ANZ Trustees currently administers over $2.4 billion in assets and has operated for over 100 years.

ANZ Trustees supports the introduction of uniform national trustee legislation by the Commonwealth (Option 1 in the Green Paper). Legislation that differs by State and Territory adds to the complexity and cost of providing trustee services, which is not in the interest of consumers, beneficiaries or charities.

The proposed regulatory arrangements of Option 1 will deliver benefits to consumers. The extent of the efficiency benefits gained by the industry and our customers will depend on the extent of legislation enacted, the regulator chosen and level of prudential oversight that is adopted and this is discussed below.

<u>Regulation of trustee companies</u>

Nationally consistent regulation

ANZ Trustees supports the rationalisation of licensing and reporting requirements across jurisdictions in order to enhance consistency in licensing requirements and reduce inefficiencies and cost in the conduct of trustee business.

One regulatory and licensing regime, overseen by a well resourced regulator, would streamline regulation and make it easier and more cost effective for trustee companies to conduct business interstate. This approach would ultimately facilitate a more competitive national market for trustee services, which would benefit customers through enhanced disclosure and protection arrangements and lower costs.

The current regulatory framework requiring state-by-state regulation reduces the efficiency of an organisation that operates nationally through the increased complexity of staff training, complexity of compliance effort and the associated professional advice and administration costs. It is also restrictive in allowing new players to enter the market and does not promote competition, all of which results in higher costs for the consumer.

In particular, the key issues affecting ANZ Trustees from the current compliance and licencing framework are:

- **Increased complexity of compliance function**: lack of uniformity particularly in the area of the various trustee companies' acts adds to the complexity of compliance registers and compliance monitoring arrangements. Compliance registers must not only reflect the differences in substantive law across jurisdictions, but also the circumstances in which the laws of one jurisdiction apply over the laws of another.

- **Increased complexity of compliance training**: differences in laws also add length and complexity to compliance training which must communicate the compliance requirements of a number of legislative regimes.

- **Compliance risks**: a lack of legislative harmonisation can increase the risk of compliance breaches because:

    - The compliance requirements of one jurisdiction may be confused with another;

    - Compliance requirements are never fully understood because the training material is necessarily complex; and

    - Changes to one state or territory's legislation are more likely to be overlooked when it is only one part in a patchwork of State and Territory legislation.

- **Increased professional advice costs**: the complexity of complying with multiple legislative requirements can increase reliance on professional advisers which in turn increases the operational costs of an organisation.

Uniform national trustee legislation by the Commonwealth should provide a consistent approach to:

- Conditions imposed on licence for individual trustee companies

- Fees

- Format of quarterly/half yearly activity statements

- Reserve requirements. For example, in Victoria a trustee company must keep a reserve fund. In Queensland there is a deposit made in the name of the Treasurer
- Restrictions on shareholdings and transfer of shares
- Liability of directors
- Authorisation of a trustee company to act as executor/administrator by the executor named in the will or person entitled to letters of administration. Provisions differ by State and in South Australia there is no provision.

However, we note that it is not proposed that all of the regulation of trustee companies would be assumed by the federal body. Legislation other than the trustee company Acts which is state-based as well as common law rules would still apply to trustee companies in each state and would continue to be regulated by state bodies as at present.

<u>Option 1</u>

ANZ Trustees supports a shift to licensing and supervision of trustee corporations by ASIC.

ASIC already regulates many of the activities of trustee companies in relation to their Australian Financial Services Licences (AFSL) and non-traditional trustee company activities. ASIC is therefore familiar with the activities of trustee companies and the industry is accustomed to working with it as a regulator. For example, ASIC regulated activities undertaken by the business include its Responsible Entity activities, custodial activities, dealing in financial products and providing personal advice on financial products. The recent regulation of unlisted unrated debentures provides an example of ASIC working effectively with the trustee industry.

ANZ Trustees agrees that some standards or requirements could be adopted from the custodial or depository services under the AFSL regime. This is a good example of where efficiencies could be gained from having ASIC as a regulator.

We also believe that a suitable level of prudential oversight can be achieved by using the framework applying to existing AFSL holders. ANZ Trustees holds an Australian Financial Services Licence [No. 234528] which provides the following Authorisations:

- Provide financial product advice for a range of financial products to retail and wholesale investors;
- Deal in a range of financial products for retail and wholesale investors;
- Provide custodial or depository services to retail and wholesale investors; and
- Operate registered managed investment schemes to retail and wholesale investors.

The business is also subject to ANZ policy and obligations by virtue of being a subsidiary of an ADI regulated by APRA.

Option 2

ANZ Trustees does not support regulation by APRA because the compliance costs and competitive neutrality issues associated with prudential regulation would be significantly greater than for a consumer protection/disclosure regime. For example, trustee companies holding an AFSL would be regulated by both ASIC and APRA, which would substantially add to cost and complexity and reduce competition by effectively restricting entry to the industry.

The likely standards to be administered under an APRA prudential regime (as listed in the Green Paper) are standards that are currently overseen by ASIC in relation to some trustee company activities. We would prefer ASIC's oversight be expanded to all trustee company activities rather than having two regulators.

Dispute resolution

Consistent with a move to a consumer protection regulatory approach, ANZ Trustees supports the Green Paper's suggestion for a cost effective and timely dispute resolution service in relation to trustee services. Current arrangements suffer from uncertainty relating to questions of jurisdiction of dispute resolution agencies.

ANZ Trustees' customers have access to ANZ's dispute resolution policy that includes recourse to our independent customer advocate and to the Financial Ombudsman Service – a third party external dispute resolutions service.

As some matters within the trustee business will remain under State jurisdiction, there will still be some matters which cannot be referred to an external dispute resolution mechanism. In these cases recourse is to Attorneys General in each state and the courts.

Fees and charges

The new national legislation should introduce reforms in relation to fees and charges. Currently, trustee company fees are regulated on a state-by-state basis in relation to trustee services offered, with a cap on fees that can be charged varying by state and by product.

Different fee levels between and within each state is confusing for consumers and it does not readily enable a consumer to compare fees for services. Further, in some States and service areas the caps have been set at a level that makes it uneconomic level for trustee companies to continue to provide certain services.

This has already resulted in some trustee companies restricting the types of business and services they offer, thus reducing competition and consumer choice.

An example of this is the income commission regime for charitable trusts in NSW. This sets a low cap on the fees that can be charged in NSW and makes administering charitable trusts uneconomic on all but the largest trusts.

ANZ Trustees would prefer that fees for trustee services be set by the market. ASIC regulation of trustee companies would ensure greater transparency in the disclosure of fees which would in turn enhance competitiveness in relation to fees for service by providing better information to consumers.

3. MARGIN LENDING

ANZ provides margin loans to over 13,000 customers. Those customers are predominantly retail.

The greatest risk to consumers taking out a margin loan is in single stock or concentrated exposures. Lending exposure to illiquid and small cap stocks is only responsible against modest loan-to-value ratios (LVRs) or within a diversified portfolio. As a result ANZ strongly supports and recommends diversification as an investment principle.

ANZ margin lending is mostly for diversified portfolio investing and while LVR ratios vary across the industry, ANZ takes a conservative approach with an average LVR of 40 per cent.

If margin lending is to be regulated, regulation should be light touch and not overly complicate the product or regulatory regime. The policy issues that should be addressed include:

- Simple, brief disclosure that is aimed at customer understanding and knowledge of the product features, benefits and risks of margin loans
- Recognition that margin lending is a distinct type of credit because the customer has the potential to lose equity in the underlying asset
- A distinction between sophisticated investors and retail customers
- Support for diversification as an investment principle.

ANZ believes that if the Commonwealth Government decides further regulation is appropriate it should be done as outlined in Option 2 of the Green Paper. This would amend Chapter 7 of the *Corporations Act* to define margin loans as a financial product, which would bring margin lending under the existing FSR regulatory framework.

The losses associated with margin lending relate to a fall in the value of the assets against which the funds are borrowed; risk is related to the asset and a drop in value can trigger a ‘margin call’. As noted in Section 1 ensuring the appropriate regulatory framework is applied to the various types of credit and lending products available is an important policy objective. Therefore, while we support the regulation of credit under the UCCC arrangements being shifted in their current form to the Commonwealth, we agree that margin lending is more appropriately regulated under the FSR regime. This is because it:

- Recognises that the issues which have emerged recently may relate to a lack of understanding of the product and the risks associated with the product, and this is consistent with the purpose of Chapter 7
- Has an advice regime that could result in quality advice, better explained by people qualified to provide financial advice
    - ANZ would also support measures to mandate disclosure in order to improve retail borrowers’ understanding of margin loans. For example, an upfront ‘key issues’ type disclosure which simply and briefly describes the product, outlines the risks and details the costs
- Could provide measures to enhance disclosure requirements, including to make disclosure easier to understand, that warns of the risk of losing equity in the underlying asset and that details in a simple manner other features of the product (e.g. who owns the shares, margin calls etc)
- Allows customers to choose the level of advice they require before entering into the product
- Recognises that the product is essentially a vehicle to facilitate a specific type of investment which has associated risks
- Utilises an existing national legislative framework which is appropriate for this particular type of credit product, rather than developing a new framework.

ANZ would also support an opt-out provision for sophisticated, high net worth investors. For example, ANZ Private Bank sells margin loans through our bankers and not our financial planners. Their customers are aware of the risks and do not wish to be burdened with additional hurdles to obtain investment products they understand.

ANZ concurs with the Green Paper’s assessment that Option 3 would create regulatory duplication for businesses offering margin loans and other financial products which would create inefficiencies for businesses that would be required to obtain separate licenses for different products and develop disclosure documents for those products under different regimes. Option 3 would not create a superior outcome than that possible under Option 2, but it would create significant inefficiencies.

4. DEBENTURES

Esanda Finance Corporation Ltd (Esanda) is a finance company, and a wholly owned subsidiary of ANZ. It is one of Australia's largest asset-based finance companies and it is the only debenture issuer which is owned by an ADI.

Esanda is Australia's largest supplier of fixed term debentures and investments are used to fund the lending operations of Esanda. Esanda is Australia's leading provider of vehicle and equipment finance and fixed interest investments, with total assets in excess of $14 billion.

The Green Paper proposes that all debenture issuers 'carrying on an investment business who regularly offer securities to retail investors and for whom such issues constitute their main source of funding' be required to obtain an Australian Financial Services Licence (AFSL).

We recognise the Green Paper's recommendations seek to address the recent failure of property development companies. However we would also want to differentiate Esanda, as a leading provider of debentures and the only one which is a wholly owned subsidiary of one of Australia's largest ADIs, from other debenture issuing companies.

The entity collapses which are the focus of the Green Paper's options for reform (and which have been the focus of ASIC's recent consultation papers and guidelines) utilised business models where retail funds were invested in speculative property developments, often with retail investors ranking behind other funders of the debenture issuing entity (e.g. Westpoint).

In light of the recent collapses, ANZ supports legislative reform to provide protection for retail investors where investor funds are utilised for speculative purposes. However, we consider that a 'one size fits all' approach is not appropriate if it requires all debenture issuers to obtain an AFSL regardless of the nature and relative risk of the issuing entity and product and the utilisation of investor funds.

<u>Esanda's rating and business model</u>

Esanda raises funds through the issue of debentures to the retail market, ANZ Group inter company lending and by issuing commercial paper. The relative proportions of its funding vary from time to time but, on average, approximately 65% of its funds are sourced from debentures.

Standard & Poor's (Australia) Pty Ltd has rated Esanda and its short term investments (terms of one year or less) as A1+ and long-term investments (terms greater than 1 year) as AA. These ratings indicate very strong capacity to pay interest and repay principal in a timely manner and are as high as those for Australia and New Zealand Banking Group Ltd and its term deposits. To our knowledge, no other debenture stock issuer has as high a rating as Esanda.

Esanda's business model differs from the business model utilised by property development issuers in a number of material respects:

1. Esanda uses funds raised from the issue of debentures to provide asset finance to individuals and small to medium businesses operating in a range of industries in Australia. Financing is offered predominantly for vehicles, plant and equipment and farm machinery. Asset finance takes the form of leases, hire purchase agreements, bailment plans, receivables financing, chattel mortgages and secured loans where the finance is secured by the asset. Esanda has over 250,000 lending customers.

2. Often property development companies have no regular cash flows until the end of the project when sales occur and the company's return on investment is unknown until the date of the sale. In contrast, most of Esanda's loans require monthly repayment which not only improves cash flow but also allows us to more closely monitor our lending portfolio and manage our risk where a customer defaults (including exercising our right to repossess the asset the subject of the finance).

3. Unlike the Westpoint business model where investments were secured against speculative property investments on terms where investors ranked behind wholesale funders, the assets which support Esanda investments are tangible property. The conservative ratios and investor priority position required by Esanda's trust deed (discussed below) mean, in effect, that not only does the asset backing provide readily realisable security but Esanda investors also rank ahead of other creditors.

<u>Existing regulation of Esanda and its debentures</u>

Trust deed

In accordance with the Corporations Act (the Act) Esanda's debentures are governed by a trust deed dated 9 November 1955 (as amended). Permanent Nominees (Aust) Limited is the appointed trustee. The trust deed contains provisions to protect investors and the trustee supervises Esanda's compliance with those provisions. The Act requires quarterly reviews of compliance with the trust deed, including in Esanda's case, its trust deed ratios and other specific requirements of the Act.

Some important investor protections in Esanda's trust deed are:

- Shareholder and asset—investment ratios - the amount of debentures on issue at any one time must not exceed the lesser of 12 times shareholders' funds (12:1) or two thirds of Esanda's liquid assets i.e. for every $1 invested in Esanda debentures Esanda must have at least $1.50 in assets. This borrowing limitation means that there are always substantially more liquid assets than debenture stock on issue. We are unaware of any other issuer of debentures that has such a conservative limitation.

- Debentures are secured by registered charges in favour of the trustee over Esanda's assets (other than land). In any liquidation, debenture holders rank ahead of unsecured creditors and ANZ.

Further, ANZ has given a revocable undertaking for the benefit of investors to maintain a controlling interest in Esanda for the term of investments made under its prospectus. If ANZ does revoke the undertaking, it will offer investors an alternative deposit with ANZ on similar terms as to interest and duration in place of their Esanda investment.

Regulatory environment

Esanda does not currently hold an AFSL. Its debentures are sold predominantly via ANZ branches and through investment brokers, pursuant to the licence held by ANZ, or the relevant investment broker.

As an ADI, ANZ is also subject to prudential regulation by APRA. As a wholly owned subsidiary and a business unit of ANZ, Esanda is effectively subject to many of the controls put in place under APRA's supervision, and in relation to its AFSL, under ASIC's supervision. These include in the areas of risk management, conflict management, dispute resolution, maintenance of financial, technological and human resources and independent audit.

In our view, no benefit would be gained for investors were Esanda required to obtain, and maintain, an AFSL as it is already subject to the controls via existing regulation that a licence would impose. Further, its risk profile does not warrant the additional significant compliance cost involved in obtaining and maintaining the licence.

<u>Review of trustee duties</u>

Esanda supports ASIC's work to list trustee duties in the new Regulatory Guide 69 *Debentures – improving disclosure for retail investors*. We would support a periodic review of the list to ensure it remains relevant to trustee duties.

ANZ would be pleased to provide any further information about this submission as required, and can be contacted as follows:

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Dear Sir

Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 – Margin Lending

Australia and New Zealand Banking Group Limited ('ANZ') is pleased to provide comments on the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009 (the 'Bill'), released in May 2009.

The comments and recommendations contained within this letter focus on those proposals in the Bill that ANZ believes require further consideration to achieve the objective of creating an efficient and effective regulatory system that provides retail client protection.

1. Definition of Margin Lending

ANZ understands the desire to regulate margin lending and the difficulty posed by margin lending being a debt facility that is usually secured by and utilised to purchase financial products. While ANZ believes that Chapter 7 of the Corporations Act is appropriate for margin lending, ANZ is concerned about the possibility of margin lending facilities being captured by the Corporations Act and the new consumer credit laws and/or the proposed laws relating to investment lending. Consumer credit legislation, is not appropriate for debt facilities secured by financial products. For example, the current consumer credit law requires the provision of one month's notice prior to the exercise of default rights. This is unworkable for a margin loan.

The most significant issue that the proposed legislation is seeking to address is the lack of understanding that consumers may have regarding the risks associated with a margin loan. That risk exists irrespective of the purpose for which funds are used. In addition, ANZ customers have in the past used the quity they have in ther share portfolio to raise capital for other purposes such as cash flow for business or investment in other asset classes. If that lending is not regulated by this proposed legislation then it either unregulated or might be captured by other credit regulation. Neither of those outcomes is desirable because both outcomes would leave the customer unprotected against the risks that this legislation is proposing to minimise. ANZ submits that the regulations should apply to Margin Loans irrespective of the purpose for which the funds are to be used

After a margin lending facility is established a borrower may drawdown funds without the lender knowing the purpose of that drawdown. A margin lender should not be required to monitor the spending habits of its customers to this level. Further, the use of a margin lending facility in part, or for a small time, for domestic purposes should not result in the facility being regulated by both the Corporations Act and consumer credit laws, or changing from being regulated by the Corporations Act to the consumer credit laws as this would prove unworkable. It should be noted that where a retail client uses the margin lending facility for domestic purposes it may be for short term cash flow reasons with the facility quickly returning to investment purposes.

ANZ submits that following establishment of the margin lending facilities, lenders should not be required to monitor the use of the lending facility. Initial assessment of the borrower's financial situation and the suitability of a margin loan should be sufficient

2. Assessment of unsuitability of margin lending facility

The draft legislation introduces new responsible lending provisions. This is a significant new legislative obligation for margin lenders. This means that before a retail client enters into a margin loan or has a credit limit increase request approved, ANZ must:

- make an assessment as to whether the credit facility or increase in credit limit is not unsuitable for that retail client having:
  - reasonably inquired about the borrower's financial situation;
  - taken reasonable steps to verify the borrower's financial situation;
  - made any inquiries prescribed by the regulators; and
  - taken any steps required by regulators to verify any matters prescribed by the regulations.

Credit must be deemed unsuitable (and must not be provided) if at the time of the assessment:

- it is likely that at that time were the facility to go into margin call the retail client could not comply with the retail client's financial obligations under the facility, or could only comply with substantial hardship; or
- if the regulations prescribe circumstances in which a margin lending facility is unsuitable (currently where the retail client is unable to be contacted on an ongoing basis and has not appointed an agent, or the retail client is unable to contract).

The assessment includes:

- determining whether the client has borrowed to make an equity contribution (double gearing), and if so, whether that borrowing is secured by residential property;
- the retail client's other debt;
- whether there is a guarantor and if the guarantor has been informed of and warned about the risks; and
- any other matter that ASIC considers relevant.

i) Income and assets allowed to be assessed.

The assessment must be made at the time of application for credit and take into account the client's ability to meet all repayments, fees, charges and costs from income and available liquid assets rather than long term savings. It is not clear what is considered long term savings. Further, it is not clear whether assessing the ability of a client to meet a margin call by selling the secured property (shares and managed funds within the margin lending facility) is acceptable.

It is stated that in making an assessment, the credit provider cannot depend upon income received from the financial products to be purchased with the proceeds of the loan, even though a margin lending facility is, by definition, an investment loan and the assets purchased could be expected to produce income in the form of dividends or distributions regardless of capital gains. A lender should be able to take into account expected income derived from the investment.

ii) Reasonable inquiries.

It is not clear what is considered a reasonable inquiry regarding a client's financial position or the steps required to verify it. However, in the commentary to the legislation (1.64) it is stated that lenders are not expected to go beyond the standard business practice in verifying information they received from the client, and in such cases can assume that the information provided by the client is true and accurate.

We believe the most appropriate assessment process depends on the the stage of the customer's relationship with a lender. It should also be a judgement based on the risk of the customer and the product. Financial institutions will have different standards for approving a margin loan, credit card, home loan or personal loan and it is not clear which is considered reasonable for a margin loan. We believe the legislation should state that a risk-based approach is to be applied.

iii) Double gearing.

There is also now a requirement for a lender to determine whether the equity contributed by a client is borrowed, and if so whether it is secured by residential property. Although the Lender may ask the client whether the equity has been raised using a residential home as equity, the Lender may not be able to verify that the client has not borrowed against the residential home, particularly if the residential home loan is with another lender. ANZ submits that a declaration by the borrower that the equity contribution is not secured by their residential home should be sufficient.

iv) Financial planners and Statements of Advice.

In earlier working group discussions and draft legislation it was envisaged that where a retail client applied for a margin lending facility as a result of a Statement of Advice (SOA) from a financial planner (where the margin loan facility applied for was for the same amount as advised in the SOA), this would meet the test of the facility being not unsuitable. The Bill now provides that the margin lender can only rely upon information contained within the SOA, not the advice. This amendment is confusing as prior to preparing an SOA a financial planner will generally undertake a fact find of the client to determining their financial position, circumstances and objectives to prepare advice that must ensure that the products recommended are appropriate for that client – a higher test than an unsuitability test. ANZ submits that advice from a financial planner should be sufficient to determine that a margin lending facility of the type and size advised by that financial planner is not unsuitable.

Further, rather than receiving a copy of the entire SOA, ANZ submits that the margin lender should only be provided with a certificate or letter from the financial planner. An SOA can be a lengthy document (some can be over 100 pages) and each financial planning group may use a different format. If a margin lender receives the entire SOA the margin lender may need to read the entire SOA to source information resulting in delays in application and increased costs.

Also, the provision of the entire SOA to a margin lender may place a burden upon the margin lender as an Australian Financial Services Licence (AFSL) holder to consider the appropriateness of other products recommended in the SOA.

Provision of the entire SOA to the margin lender may increase the risk to the margin lender. Many margin lenders are part of large financial institutions and may be more financially secure than some financial planning groups. If the advice within the SOA subsequently leads to loss for the client, the client may look to the margin lender for recourse for implied knowledge and consent rather than the financial planner.

v) Timeframe of Statement of Advice.

ANZ submits that the proposed 30 day timeframe for reliance upon an SOA is insufficient and that the timeframe should be extended to 90 days. The 30 day period currently commences from when the SOA is prepared which may be some time prior to the SOA being presented to the client, read and considered by the client and finally accepted. Furthermore, it is also not clear whether an SOA is considered to have been prepared when the SOA is finished or when it is started.

ANZ understands that financial planners will ask a client to confirm that no material change has occurred prior to signing the SOA and, as such, believe that the timeframe should commence upon acceptance of the recommendations made in the SOA or execution of a certificate by the financial planner..

3. Transitional arrangements

The proposed transitional periods provide very short timeframes for what is a major overhaul of the margin lending industry. Margin lenders will be required to draft new documentation (a Product Disclosure Statement ('PDS')) as well as redraft existing documentation, terms and conditions and marketing material. Systems relating to assessment of applications or the execution of margin calls will need to be amended or potential completely new systems designed and built. This will present significant challenges for ANZ.

i. Systems and process changes

ANZ will be required to undertake major systems and process changes to:

- change existing forms, terms and conditions and disclosure documents;
- meet record-keeping obligations (including unsuitability assessments);
- develop and implement an unsuitability test in line with regulatory requirements; and
- develop new margin call procedures and processes in line with regulatory requirements.

It is noted that the unsuitability test and margin call provisions come into effect once a margin lender applies for a new AFSL or a variation to an existing AFSL and that this may require the margin lender to have redrafted documentation and applications and redesigned and built new systems and processes within one month of the Bill receiving assent. This is not possible.

ii. Training

4. Margin calls

ANZ notes that ASIC may make determinations about when and how margin calls can occur. We would encourage that any such determination be required to take into account the nature of margin lending facilities, the financial markets and the need to act without delay. In doing this it should be noted that in specific instances (such as the severe market collapse recently experienced) the number of margin calls may be severe and normal communication methods and timing may not be suitable. This is particularly relevant if, due to new regulations, staff dealing with customers must meet a specific training requirement meaning that resources in other business units or call centres could not assist.

5. Provision of unsuitability assessment

Section 985H(2) of the Bill provides that if a retail client requests a copy of the unsuitability assessment any time up to 12 months after closing the facility, the margin lender must give the retail client a copy within 2 business days. In practice this may result in a request 12 years after the assessment, within only 2 business days allowed for the assessment to reach the client's hand, with failure to comply an offence. ANZ cannot understand the need for such speed post applying for a facility and submits that this should be extended to at least 10 business days.

6. Periodic statements

ANZ supports the need for customers to receive regular statements regarding their margin loan facility and ANZ currently provides statements to margin lending clients monthly.

ANZ submits that in bringing margin lending into Chapter 7 of the Corporations Act, it be clarified that the usual requirements for a Chapter 7 periodic statement be amended to remove the requirement for a termination value. It is common for retail clients to fix all, or part, of their margin loan. Fixed loans are subject to termination costs that are determined taking into account the fixed loan amount, time to maturity, rate and the yield curve to determine the cost of breaking that facility and all calculations of break costs for a fixed loan facility necessitate calculations from ANZ's treasury department for each individual fixed loan. If termination value is required for margin lending periodic statements, the time to calculate these costs would be substantial, and consume considerable resources and cost. It is also likely that if this was required the time between the month end and the provision of the statement to clients would be extended substantially, making that estimated termination value irrelevant by the time it is in the hands of the client. Alternatively, the frequency of statements would need to be reduced.

ANZ would be pleased to provide any further information about this submission as required and can be contacted as follows.

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ANZ will need to ensure that its representatives working in this department are adequately trained and are competent to interact with customers in line with the new regulatory framework. A number of client facing staff will need to be trained. This could take at least 9-12 months to ensure that staff are trained and RG 146 compliant.

iii. Other requirements likely to impact on timing:

There are also a number of other factors which will affect ANZ's ability to meet the proposed timeframe. These include:

- risk assessment and contractual arrangements for intermediaries (stock brokers, financial planners, accountants etc).
- other new regulations which we will also need to comply with (eg unfair contracts, consumer credit); and
- engagement of additional staff required to undertake additional verification of a customer's financial details.

Previously when similar legislative changes have been made (eg FSR, introduction of the UCCC), transition periods of two years have been provided. This allows licensees to make the changes necessary to comply with minimal disruption to business. It is highly likely that in the absence of such a transition period, and faced with significant penalties for non-compliance, ANZ may be required to, at least temporarily, not make margin loans available to retail clients.

Given the extensive amendments to credit legislation generally, the amendment to licensing obligations, the need to ensure all relevant staff are trained and the product is compliant and the required systems changes are made (especially with the large number of other legislative changes currently impacting financial institutions and concurrent amendments being required by the Australian Stock Exchange), a two-year transition period should be allowed before the legislation comes into effect.

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Yours faithfully

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